IN THE

Supreme Court of the United States

October Term, 1978.

No. 78-1767

WILMINGTON TRUST COMPANY,
as Successor Indenture Trustee,

Petitioner,

v.

PENN CENTRAL TRANSPORTATION COMPANY,
as Debtor,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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Appendix.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1698, 78-1699, 78-1700, 78-1702, 78-1703, 78-1710, 78-1711, 78-2311, 78-2312, 78-2314, 78-2315, 78-2319 and 78-2320

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Debtor

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(Appeal from D.C. Order No. 3707)

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Submitted Under Third Circuit Rule 12(6)
October 16 and 17, 1978

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Appellants in No. 78-1711
(Appeal from D.C. Order No. 3455)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

(D.C. No. B-70-347 In Bankruptcy)

Submitted Under Third Circuit Rule 12(6)
October 16 and 17, 1978

Argued October 16 and 17, 1978
(except where otherwise noted)

Before: ALDISERT, GIBBONS and HIGGINBOTHAM, *Circuit Judges.*

(Opinion filed January 11, 1979 as Amended)

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AMENDED OPINION OF THE COURT

ALDISERT, *Circuit Judge.*

We have before us numerous appeals from the Penn Central Transportation Company reorganization court's orders of approval, confirmation and consummation of a Plan of Reorganization. Satisfied that the Plan is fair and equitable as to these appellants, we affirm.

Plans of reorganization for Penn Central and for fifteen secondary debtors (collectively, The Plan) have been approved by the reorganization court, and upon submission to claimants for a vote, have been accepted by an overwhelming majority of claimants. Related appeals also decided this day are *In the Matter of Penn Central Transportation Company, Debtor, (Irving Trust and Bank of New York Appeals),* — F.2d — (3d Cir. Nos. 78-1698; 78-1692/1694; 78-1716; 78-2314; 78-2316/18); *In the Matter of Penn Central Transportation Company, Debtor, (Stockholder Appeals),* — F.2d — (3d Cir. Nos. 78-1715, 78-2321 and 78-2336). These appeals present issues which require us to review the basic framework of the monumental plan designed to resolve what may be the most complex set of interrelated and conflicting claims ever addressed under Section 77 of the Bankruptcy Act, 11 U.S.C. § 205.

The questions for decision are:

1. Whether the Plan, in providing Series A preference stock to certain bondholders whose mortgage liens were recognized by the reorganization court to have somewhat superior coverage (the so-called "super-secured" creditors), adequately provides for them.

2. Whether the Plan properly excludes certain bond issues from that "super-secured" class.

3. Whether the Plan adequately protects the interests of the Erie and Kalamazoo Railroad Company, a non-bankrupt leased line of Penn Central.

The history of this reorganization proceeding and the characteristics of the Plan are set forth in an extensive opinion by the Honorable John P. Fullam, judge of the reorganization court (I, A-1345-1457). To put in proper perspective the nature of these appeals, it is necessary to understand the theory of the Plan, and to understand this theory it is first necessary to review the history which forms the backdrop for this mammoth reorganization.

I.

Penn Central Transportation Company (PCTC), the debtor, was formed in 1968 by the merger of the Pennsylvania Railroad Company and the New York Central Railroad Company. The "Pennsy" and the New York Central can be traced almost to the beginning of railroad transportation in the United States. By the 1870's they had created, by construction and purchase, railroad systems

extending from the eastern seaboard to the Mississippi River. In spite of the difficulties facing the rail industry in the 1930's, both railroads, because of their financial strength, were able to function as viable, successful companies. Both systems had been created in large part through lease or purchase of stock of a large number of separate railroad companies, many of which had substantial amounts of their own securities outstanding. Both legal and financial obstacles made it difficult to change the original relationships and subsequently added to the complexity of the Penn Central reorganization.

The Interstate Commerce Commission conditioned its approval of the merger between the Pennsylvania and New York Central railroads on the acquisition of the New York, New Haven and Hartford Railroad Company (New Haven) by the newly formed Penn Central. The New Haven, a system in southern New England with many operating relationships to the merged companies, had been in reorganization proceedings under Section 77 of the Bankruptcy Act since 1961.

There is some suggestion in *The Financial Collapse of the Penn Central Company*, Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations (August 1972) (SEC Report), that the Pennsylvania-New York Central merger may not have been realistically planned:

> No consideration was given in connection with this merger to the broad question of realinement of the Eastern roads or whether this was the best merger for the two roads. They were, in effect, the leftovers, after other combinations had been individually arranged. Furthermore, little consideration appears to have been given to the question of whether this particular merger would work at all. Certainly the combination of two already ailing and financially weak roads raises questions as to feasibility and in this situation the possibility also existed that the size and complexity of the merged company would preclude manageability.

SEC Report, *supra*, at 17. Additionally, whatever flaws were inherent in the plan to merge were exacerbated by ICC requirements and labor difficulties:

> By the time ICC's approval was obtained, two decisions had been made which many people have suggested sealed the doom of the company. Neither had been contemplated at the time of the original proposal. First, in May 1964, the two roads reached an accord with labor, the Merger Protective Agreement, whereby they, in effect, bought the cooperation of the unions, which had been opposing the merger. The result of this agreement would be to cause the company to incur costs far above those anticipated in the Patchell report and thus limit the savings projected. The second factor was the decision of the ICC to force the New Haven Railroad on the Penn Central, adding still a third financially and operationally weak road to the group.

Id., at 18. When merger was completed, the initial expectation that increased size would bring with it increased efficiency and profits began to fade into the dismal reality of misrouted cars, management problems, uncertainty of internal procedures, deterioration of the physical plant, and high-level in-fighting. An officer of the company, in a speech to a group of shippers in March 1969, described one aspect of the operations problem as follows:

> This period of transition from two railroads to one harmonious system has not been easy. One of the

reasons for our difficulty can be found in the size of the plant itself. While our lines paralleled each other in a number of areas and we shared many common points, the Pennsylvania and New York Central systems were not complementary. Our separate yards did not have the individual capacity to handle the combined business of the two railroads, and we have had to keep several yards in operation until combined facilities can be built.

Our separate communications systems were not compatible and this complicated some of the service problems created by the merger. This situation has been aggravated by confusing routing symbols, particularly from off-line sources. For example, a car routed Penn Central-Cincinnati that should have gone to the former Central yard in Cincinnati often has ended up in the old Pennsylvania yard and frequently its waybill papers went astray as well. In addition, employees of the former Pennsylvania were not familiar with the properties and procedures of the former New York Central, and vice versa. A great deal of cross-pollination had to take place in the process of finding the most efficient way to handle traffic.

. . .

An internal memorandum prepared about the same time and intended for use by top-level management personnel as a basis for response to numerous press inquiries about the road's "lousy" freight service relates the following:

> From the beginning of merger discussions it was recognized that it would be necessary to continue parallel operations over the lines of the two former railroads until terminals could be integrated, connections constructed, and yards expanded along principal routes. Before the merger was consummated, arrangements were made with our principal connecting carriers that blocking of traffic and interchange would continue as before merger, with gradual changes to be made as construction and operational arrangements were completed to permit integration on an orderly basis. For a while following merger, operations were maintained in accordance with this plan, and deterioration set in only when there was a relaxation in the preclassification and delivery arrangements at major gateways, such as St. Louis and Chicago. The problem was unintentionally compounded when shippers began to route their freight "PC" rather than via "PNYC(P)" or "PNYC(N)" thereby failing to direct their traffic to one or the other of the former railroads.
>
> The principal effect of these changes was to create congestion and confusion at major gateways and to shift the classification functions of those terminals to internal yards, thus spreading the congestion eastward. This initial disruption triggered a number of collateral effects: It widened the margin for error by clerical personnel who were unfamiliar with stations and consignees to which they were routing traffic; it disrupted the cycling of locomotives and thereby produced sporadic power shortages; it placed an unmanageable tracing demand upon a data processing system already beset with the problems in incompatibility; it caused separation of cars from billing as emergency steps were taken to clear congested yards; it prompted short-haul-

> ing of Penn Central, thereby increasing the switching burden at interchange points with other eastern carriers—and as these adversities snowballed one after another the speed and reliability of our service deteriorated steadily.

Id., at 21-22 (footnote omitted). In sum, the merged railroad faced operational, financial and management problems which, in large part, were not anticipated and which ultimately led to its collapse.

Notwithstanding these difficulties, the annual reports for 1968, 1969 and 1970 were misleadingly optimistic, according to the SEC Report:

> As we review the disclosure history of Penn Central, we get a picture of high euphoria and inflated prospects about the savings to be achieved by the merger with the manifest difficulties ignored or overlooked. When these difficulties emerged as painful realities, they were inadequately disclosed. The annual reports put out for 1968, 1969, and 1970 obscured the railroad's further movement into debt amid mounting operating losses. Instead they emphasized that efficiencies, improvement in service, and new exciting revenue sources were just around the corner.
>
> . . .
>
> The staff report shows that as both the operating and liquidity condition of Penn Central deteriorated, its management made increasingly strenuous efforts to make a bad situation look better by maximizing reported income. An elaborate and ingenious series of steps was concocted to create or accelerate income, frequently by rearranging holdings and disposing of assets, and to avoid or defer transactions which would require reporting of loss. Accounting personnel testified that they were constantly under intense pressure from top management to accrue revenue optimistically and underaccrue expenses, losses, and reserves, to realize gain by disposing of assets and to charge losses to a merger reserve which would not take them through the income statement. Gains were reported on real estate transactions in which the realization of benefits to the company depended on operating results far into the future and in which there was little if any real change in the character or amount of assets owned by Penn Central.

Id. at ix-x. An already complex situation was further complicated in 1969 by a second merger: the Penn Central Company, which had operated the merged Pennsylvania and New York railroads, was renamed Penn Central Transportation Company and became a wholly owned subsidiary of a new holding company, the Penn Central Company. In other words, the old Penn Central Company was renamed Penn Central Transportation Company and the new holding company took over the subsidiary's old name, Penn Central Company. The purpose of the reorganization was to facilitate diversification and consolidation of the railroad business.

By 1970, PCTC had reached the point where it could no longer raise the money to pay the escalating cash losses incurred in its operations. In retrospect, it had been relying upon use of short term credit to pay its cash deficits in the expectation that the projected merger savings would restore its financial health. The short term borrowings were about at the half billion dollar level; the immediate fruit of the merger was expensive new problems, well publicized; and its 1969 financial statements, once analyzed, indicated that the financial results of operations were rapidly deteriorating rather than improving. After an unsuccessful attempt to secure government financing,

PCTC sought relief under the Bankruptcy Act. The 1968 and 1969 mergers, the inclusion of the New Haven, already in reorganization, and the complex capital structures of the merged railroads has required the reorganization court to deal with a bewildering number of companies and security issues.

A.

On June 21, 1970, two years after the merger of the Pennsylvania and New York Central railroads, Penn Central filed a petition for reorganization under Section 77 of the Bankruptcy Act. At that time, the merged system had approximately 40,000 miles of track in sixteen states, the District of Columbia and two Canadian provinces. Since its inception, the bankruptcy of the Penn Central and the subsequent reorganization proceeding have been different from all prior railroad reorganizations. *In re Penn Central Transportation Co.*, 384 F. Supp. 895, 902 (Sp. Ct. 1974) (180-Day Appeals). Whereas earlier railroad insolvencies had typically been caused by inability to meet fixed charges or debt maturities, the bankruptcies of the Penn Central and the other northeast railroads were precipitated by their inability to meet the operating expenses and taxes of their railroad business. *Id.* at 903. The collapse of their capacity to provide rail service in turn precipitated a "rail transportation crisis seriously threatening the national welfare." *See Regional Rail Reorganization Act Cases*, 419 U.S. 102, 108 (1974) (*"Rail Act Cases"*). And this crisis in turn prompted a public response unprecedented in the long history of railroad reorganization.

For more than two years the trustees tried to reorganize the Penn Central by pressing for the realization of the conditions they deemed essential to its viability. By 1972, however, the ICC had recognized that the trustees' most recent report had constituted "a public notice that a successful reorganization of Penn Central could not be accomplished wholly within the means provided by Section 77 of the Bankruptcy Act." [1] It was becoming clear that congressional intervention would be necessary to solve the complex problems affecting Penn Central and a number of other eastern railroad systems.[2]

Various reports in February 1971, September 1971, and April 1972, by the trustees attempted to show that the system was a viable, private economic entity. The reorganization court reported:

> In February of 1973, the trustees again, eschewing nationalization, but apparently reconciled to the inevitability of delay before the conditions of viability could be achieved, concluded that plant improvement in the range of $600 to $800 million would be necessary and that the only source of this financing was the United States. Absent such capital investment, even a sharply reduced freight system would not be viable.
>
> The dilemma facing the trustees was that each day the estate operated additional deferred charges were accruing. Time was expensive. High administration expenses gave rise to two concerns; first, the potential economic viability of any railroad which might emerge was diminished by each increase in high-priority obligations; second, the continued accrual of administrative expenses would soon reach the point of being an unconstitutional impairment of the rights of the estate's creditors." [3]

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1. Comments of the Interstate Commerce Commission on the Report of the Penn Central Trustees on Reorganization Planning, 1011 Corp. Reorg. Rep. (Penn Cent.) 2612 (March 15, 1972).

2. The Reading System, Central Railroad of New Jersey, Erie-Lackawanna Railway, Lehigh Valley Railroad, Lehigh and Hudson River Railroad, and Ann Arbor.

3. By petition dated March 16, 1973, the New Haven Trustee asked the Court to order a complete cessation of operations by

With mounting opposition from creditors who feared the continued erosion of the estate in deficit rail operations, the trustees acknowledged in 1973 the impossibility of reorganizing the railroad without federal aid of massive proportions.[4]

Pursuant to an order of the reorganization court, the trustees filed with the ICC on July 2, 1973 a plan of reorganization for Penn Central. The New Haven trustee and Penn Central Company also filed plans.[5] The ICC held hearings on those plans over the summer; it reported on September 28, 1973,[6] holding that because the plan of the trustees did not provide concretely for the continuation of rail services, it did not constitute a "plan of reorganization" under Section 77 of the Bankruptcy Act. Accordingly, approval of this and the other two plans was withheld. As creditors moved to dismiss the reorganization[7]

3. (Cont'd.)
October 1973. Petition of the New Haven Trustee Concerning Reorganization Planning for Penn Central, for Instructions to be Given the Trustees with Respect Thereto and as to Related Matters, 1011 Corp. Reorg. Rep. (Penn Cent.) 4568 (March 16, 1973).

4. Trustees' Interim Report of January 1, 1973, 1011 Corp. Reorg. Rep. (Penn Cent.) 4352 (Jan. 1, 1973), and Trustees' Interim Report of February 1, 1973, 1011 Corp. Reorg. Rep. (Penn Cent.) 4446 (Feb. 1, 1973).

5. A Plan for Reorganization of Penn Central Transportation Company, Debtor, Pursuant to Section 77(d) of the Bankruptcy Act, 1011 Corp. Reorg. Rep. (Penn Cent.) 4685 (June 27, 1973); Plan of Reorganization of Penn Central Transportation Company and Certain Other Railroad Corporations, 1011 Corp. Reorg. Rep. (Penn Cent.) 4764 (Aug. 10, 1973).

6. Preliminary Report of Interstate Commerce Commission, Fin. Doc. No. 26241, 1102 Corp. Reorg. Rep. (Penn Cent.) 86 (Oct. 5, 1973).

7. Motion of the New Haven Trustee for Dismissal of the Reorganization Proceedings and Petition for Acceptance of the Within Petition as a Complaint Instituting a Civil Proceeding for Receivership of the Debtor, for Appointment of Receivers, for Cessation of Rail Operations and for Related Matters, 1011 Corp. Reorg. Rep. (Penn Cent.) 4794 (Oct. 9, 1973).

or to halt rail operations,[8] Congress enacted the Regional Rail Reorganization Act of 1973 (RRRA).[9]

B.

The RRRA created the United States Railway Association (USRA), a federal agency, to develop plans for revitalizing railroad services in the region and to administer various grant and loan funds. Among other things, USRA was to decide which lines or parts of lines were necessary to federal reorganization. The Act also directed creation of Consolidated Rail Corporation (Conrail), a railroad company and successor to some of the routes served by the bankrupt Penn Central. The Act required the conveyance of major portions of Penn Central's rail assets to Conrail free of encumbrances, and the continuation by Penn Central of its rail operations in the interim. Although the Act contemplated that Conrail would be a corporation owned by investors rather than a federal agency, at present it is financed by the United States. Further, the Act provided that a Special Court would have original and exclusive jurisdiction to dispose of all disputes arising from implementation of the reorganization. The Supreme Court sustained the Act against constitutional challenge,[10] recognizing it as a unique extension of the bankruptcy powers of Congress.[11] The Court upheld the unconventional central provision of the Act—mandatory conveyance of the estate's rail assets before judicial approval of the terms of the transfer—in light of the assur-

8. Statement of Position of Institutional Investors Penn Central Group and Certain Indenture Trustees in Response to Order No. 1321, 1011 Corp. Reorg. Rep. (Penn Cent.) 4798 (Oct. 12, 1973).

9. Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (Jan. 2, 1974); 45 U.S.C. § 701 *et seq.*

10. Rail Act Cases, 419 U.S. 102 (1974).

11. Rail Act Cases, 419 U.S. at 153.

ance found in the Tucker Act, 28 U.S.C. § 1491, that full compensation for those assets would be paid.[12]

In April 1976, pursuant to court order but prior to a valuation, Conrail acquired certain of the railroad property of Penn Central. In general Conrail did not acquire lines or parts of lines which USRA considered unnecessary. Properties not acquired by Conrail were divided into two categories: lines authorized by the Act to be abandoned or scrapped, or lines which could be operated if state or local authorities provided for continued service, backed by a subsidy sufficient to ensure the owner against loss. It was not intended that Penn Central would resume any railroad operations.

Conveyance to USRA took place in 1976. But before the conveyance took place, Congress made a number of important amendments to the RRRA including Section 306 of the Act, which authorized the issuance of Certificates of Value, and the Section 211(h) loan program. Section 306 Certificates of Value are interest-bearing USRA securities redeemable on December 31, 1987, constituting a pledge of the United States to make up with cash any difference between the net liquidation value of the assets conveyed by Penn Central and other northeast bankrupt railroads and the value of Conrail stock and other benefits conferred on the estates by the RRRA.

The reason for the enactment of the Section 211(h) loan program was that as the time for conveyance approached, it was apparent that Penn Central's payables were in excess of its receivables. The situation was potentially tantamount to a second bankruptcy since Conrail was not to assume any liability for Penn Central's pre-conveyance obligations. Section 211(h) created a mechanism by which Conrail borrowed from USRA in order to pay certain classes of the debtor's payables. In turn, the estate

12. Rail Act Cases, 419 U.S. at 149, 152.

was obligated to recognize as a current cost of administration the amount of 211(h) funds expended by Conrail on the estate's behalf.

C.

An understanding of the Plan also necessarily involves consideration of the non-rail business of the estate. These substantial and profitable non-rail operations and assets held out the promise that Penn Central could function as a non-rail enterprise. Principally, these assets included non-rail businesses operated through Pennsylvania Company (Pennco), a wholly-owned subsidiary of PCTC, and various income-producing real properties in New York City and elsewhere. In the income statements filed by the trustees for the years 1970-75, a total of $244,462,000 of non-rail income was reported.[13]

In developing a plan of reorganization which took account of these considerations, the trustees could derive guidance from two significant events involving major non-rail assets that had occurred during the course of reorganization.

1.

Having previously announced their intention to sell all of the Park Avenue properties in New York City, in March 1972 the trustees petitioned to six sell of them at prices aggregating $59.5 million.[14] Various creditors raised ob-

13. By years, the "other income" was 1970: $55,145,000; 1971: $31,373,000; 1972: $37,927,000; 1973: $38,756,000; 1974: $40,931,000; 1975: $40,330,000.

14. Petition of Trustees for Authority to Sell the Vanderbilt Concourse Building, Penn Cent. Doc. No. 2870 (March 13, 1972); Petition of Trustees to Sell 350 Park Avenue, Penn Cent. Doc. No. 2871 (March 13, 1972); Petition of Trustees to Sell 280 Park Avenue, Penn Cent. Doc. No. 2872 (March 13, 1972); Petition of Trustees to Sell 280 Park Avenue, Penn Cent. Doc. No. 2873 (March 13, 1972); and Petition of Trustees to Sell 230 Park Avenue and 245 Park Avenue, Penn Cent. Doc. No. 2874 (March 13, 1972).

jections to that sale, arguing that the proceeds of the sale would inevitably and improperly be used directly or indirectly to support hopelessly losing rail operations, and that the possibility of an ultimate plan of reorganization for Penn Central was threatened by the divestiture of those earning assets. At that time, those assets were producing $4.4 million annually, *In re Penn Central Transportation Co.* (*"Park Avenue Properties"*), 354 F. Supp. 717, 750-51 (E.D. Pa. 1972), *aff'd in part and rev'd in part*, 484 F.2d 323 (3d Cir.), *cert. denied*, 414 U.S. 1079 (1973), and with other non-rail properties were properly regarded as constituting the key to any attempt to formulate a plan of reorganization. The district court denied the petition in part, but approved the sale of four parcels for an aggregate of $14 million. 354 F. Supp. at 746-51. On appeal, the creditor interests urged that a reorganization court [illegible] not approve piecemeal disposition of such non-rail assets in the context of a program to divest all major non-rail assets, and that, apart from extraordinary circumstances, no such program for divestiture of non-rail assets could be pursued except in the context of a plan of reorganization. In June 1973 this court sustained that view, holding:

> In the context of this case, if such sales are to take place, they must be made as part of a reorganization plan, approved pursuant to the provisions of sections 77(d) and 77(e).

In re Penn Central Transportation Co., supra, 484 F.2d at 334.

2.

The second major controversy involved Penn Central's ownership and pledge of the common stock of Pennco. That stock had been pledged to the Secured Bank Creditors as collateral for a $300 million pre-bankruptcy loan. In July 1972 the trustees petitioned the court to approve a settlement of the claims of the Secured Bank Creditors which provided that the common stock of Pennco would be transferred to the banks subject to conditional provisions permitting Penn Central to share in certain appreciation in value of that stock.[15] That petition was opposed upon the ground that the common stock of Pennco was essential to an ultimate reorganization and that a settlement of the kind proposed could not be carried out except in the context of a complete plan. The appropriate value of Pennco to Penn Central was also put in issue. In April 1973 the reorganization court denied the petition stating:

> In a straight bankruptcy, the relevant consideration presumably would be the price which Pennco could be sold for; that is, whether there is any "equity" over and above the banks' claims, and whether the Trustees should "disclaim." In a railroad reorganization context, however, the potential value of Pennco to the reorganized company must also be considered.

Opinion and Order No. 1189, 1011 Corp. Reorg. Rep. (Penn Cent.) 4609, 4616 (April 16, 1973).

In light of the conveyance of the rail assets and the judicial insistence that the non-rail assets should not be disposed of except as part of a plan of reorganization that would contribute the value of these assets to the entire enterprise, fresh efforts to formulate a fair and equitable plan were undertaken. These efforts were focused on an attempt to construct a plan that would take account of (1)

15. Petition of the Trustees for Approval of a Settlement Agreement dated as of February 25, 1972, and the Terms and Conditions Set Forth Therein and Authority to Consummate the Transactions Contemplated by Such Agreement, 1011 Corp. Reorg. Rep. (Penn Cent.) 3472 (July 17, 1972).

the income-producing continuing businesses owned and managed by Pennco; (2) the cash to be generated through liquidation of non-essential remaining assets (the "asset disposition program"); and (3) the constitutionally assured expectation that a significant award would be made in the Valuation Case, understanding all the while that both the time and the amount of the award were unforeseeable. The alternative to such a plan, it was believed, would be to embark on decades of litigation, with the concomitant waste of valuable and productive assets and accrual of increasing claims. Any plan, in order to be fair and equitable to the competing claims against the estate, would also have to take into account a basic reality of this reorganization proceeding: that the validity, priority or amount of virtually every claim was under attack in one way or another.

II.

The principal compromise settlements embodied in the Plan concern the major claims of the federal government, a consortium of New York banks and trustees of the New Haven Railroad.

A.

The government's claims possess the questionable virtues of astronomic size and statutory priority. These claims include $50 million, plus interest, due on trustee's certificates in default since 1976, approximately $350 million, due or to become due under the Section 211(h) program, and the guarantee of the balance of $50 million in trustee's certificates which fall due in 1986. Under the compromise reached with the federal government, payment of the $50 million in defaulted trustee certificates is deferred until the consummation date under the Plan. All other claims are deferred until the conclusion of the Valuation Case, and the government agrees to accept the distributions provided for in the Plan, and to support the Plan. "Without such deferrals," observed the reorganization court, "there obviously could be no Plan of Reorganization, and no claims of other creditors could be paid until the government claims were satisfied in full." [16]

B.

In the period between the merger in 1968 and the bankruptcy in 1970, Penn Central obtained much of its working capital by means of a short-term, revolving credit arrangement with a consortium of banks, for which Citibank acted as agent. The short-term arrangement was designed as a prelude to long term mortgage financing which did not materialize, initially because of unfavorable market conditions, and later because of Penn Central's rapidly deteriorating financial condition. A few months before bankruptcy the revolving credit arrangement was increased, with Penn Central pledging the stock of its subsidiary corporation, Pennco, to the Citibank group as collateral for a $300 million revolving credit authorization. The entire $300 million was drawn down before bankruptcy. No payments have ever been made on this indebtedness. Treated as a fully secured claim, entitled to interest at the contract rate, the claim would now aggregate more than $470 million. It is secured by the asset, Pennco, the surviving company which is absolutely essential to the success of the Plan. I, A-1372.

The proposed Plan embodies a compromise resolution of many issues associated with this credit arrangement including a possible violation of Section 10 of the Clayton Act. Monumental problems are associated with this potential litigation and the Plan embodies a compromise reso-

16. I, A-1370.

lution of sophisticated issues. As stated by the reorganization court: "The banks' total claim is fixed at $440 million. The banks further give up any rights they may have to assert a secured position by reason of the cash held on deposit when the bankruptcy petition was filed, or any priority arising from this Court's injunction against setoffs. With respect to the $440 million claim, the banks would receive the same treatment as other secured creditors. That is, the claim would be recognized as fully secured, but allocated as between retained and conveyed assets (61% retained, 39% conveyed)." [17]

C.

Finally, it is necessary to consider the secured claim of the trustee of the New Haven Railroad in the amount of $208.5 million, stemming from the inclusion of the New Haven in the Penn Central merger in 1968. The price to be paid by Penn Central for the New Haven properties was finally adjudicated by the Supreme Court shortly after Penn Central filed its reorganization petition. *New Haven Inclusion Cases,* 399 U.S. 392 (1970). Upon remand from the Supreme Court the New Haven reorganization court imposed an "equitable lien" upon all the former New Haven assets in the hands of Penn Central. Later vacated for jurisdictional reasons, it was reinstated by the Penn Central reorganization court as "a lien, indeterminate in amount, and indeterminate as to priority, upon all the real property and readily identifiable tangible personal property (exclusive of rolling stock) . . . conveyed to Penn Central" by the New Haven trustee. *In re Penn Central Transportation Co.,* 337 F. Supp. 779, 791 (E.D. Pa. 1971). The New Haven trustee also holds $34 million of Penn Central Divisional First Mortgage Bonds secured by the

17 I, A-1375.

properties previously owned by the New Haven and has asserted various claims based upon alleged misrepresentation or fraud on the part of Penn Central's pre-bankruptcy management.

Under the settlement agreement, all of these disputes are resolved by a secured claim in the amount of $121 million and an unsecured claim in the amount of $53 million. "The settlement is well within the range of reasonably likely litigation possibilities," observed the reorganization court, "and the litigation would obviously be lengthy and expensive. It is significant that no one has expressed any objection to the settlement arrangement. I conclude it is fair and reasonable, and should be incorporated in the Plan." [18]

III.

When the Penn Central properties were conveyed to Conrail, the parties disagreed strongly about the valuation of the property conveyed under the final system plan; they also disagreed with the valuation standards to be applied under the RRRA and about the value of the Conrail securities offered in exchange. The RRRA created a special three-judge federal court with original and exclusive jurisdiction to dispose of all disputes arising from implementation of the final system. The securities issued by Conrail were deposited in the court at the time of the conveyance, which was made pursuant to the order of the special court. Cases have been commenced in that court by representatives of the affected railroads, and by other parties to determine the net liquidation value of the property conveyed, and the "compensable unconstitutional erosion, if any" suffered during the pre-conveyance period. This is referred to as the "Valuation Case" which is an important

18. I, A-1376.

ingredient in the final plan of the Penn Central reorganization.

The SEC reports that the book value of the property conveyed to Conrail by the Penn Central system on April 1, 1976, was approximately $3.2 billion (I, A-1124), but USRA estimated the net liquidation value of this property, discounting future liquidation proceeds to 1976 values, at some $485 million (I, A-1377). It bears mention that in its October 12, 1977, valuation opinion, the special court noted: "It seems incredible that these 19,000 miles of railway and freight and passenger terminals, together with the equity in rolling stock, were worth only $685 million, the sum arrived at in the revised [Master Liquidation Plan] of March 1, 1976." [19]

It will be recalled that RRRA required Penn Central to continue operations until the federal agency decided what lines or parts of lines were necessary under the federal reorganization. The continued operations of the railroads created special problems, including some of constitutional dimensions that commanded the attention of the Supreme Court in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974). The SEC reports that an analysis of the operation of Penn Central for a six-year period, 1970-1975, "shows aggregate book losses of $1.8 billion. Excluding major bookkeeping adjustments, the aggregate losses were about $1.4 billion and continued operation was financed primarily by non-payment of taxes and fixed charges, aggregating about $1.2 billion and about $190 million of special loans, including the funds drawn from affiliates. Although $600 million of book losses represented depreciation and similar noncash items, this was more than balanced by actual expenditures, aggregating about $667 million on equipment obligations, property additions and expenditures charged to reserves. Funds

19. I, A-1380.

placed in escrow approximately equalled the net proceeds of property sold, including the gains taken into income." [20]

Under the Railroad Revitalization and Regulatory Reform Act of 1977, certificates of value, new securities issued by USRA, are backed by the full faith and credit of the United States as a partial guarantee of the value of the Conrail securities the estates are to receive in exchange for the properties. The amended statute requires the special court to make findings as to the amount, if any, of compensable unconstitutional erosion incurred by the estates between the passage of the Act and the actual conveyance to USRA. The special court will also make findings as to the net liquidation value of the conveyed properties.

Judge Henry J. Friendly's opinion for the special court in *In re Valuation Proceedings under §§ 303(c) and 306 of the Regional Rail Reorganization Act of 1973*, 439 F. Supp. 1351 (Special Ct. 1977) (Erosion Opinion) expresses the view that "[u]nconstitutional erosion arises only when a losing business has been required to continue to operate against its will for more than a reasonable period," and that the term "against its will" means "that some identifiable agency of government having power to do so should have thwarted its desires [to cease operations]," 439 F. Supp. at 1356. Two kinds of erosion must be considered—financial erosion refers to the creation of claims against the debtor's estate which prime the claims of pre-bankruptcy creditors, both secured and unsecured; physical erosion refers to reduction in the value of the physical assets and depletion of cash. As in other aspects of these proceedings, formidable erosion claims have been asserted. For example, Penn Central asserted a claim for compensable unconstitutional erosion of approximately $900 million. *Id.* at 1354-55.

20. I, A-1131.

IV.

The Plan is constructed on the basic premise that the estate is solvent. It uses as the foundation for the reorganized company Pennco, a wholly owned subsidiary of Penn Central which has substantial assets, earnings and future earning potential, enhanced by the existence of large operating loss carryforwards. Other retained non-operating assets of the debtor will be sold in the asset disposition program and the proceeds, together with the recovery in the Valuation Case, will be used to satisfy claimants. Necessarily, the Plan embodies compromises within the range of probable results of litigation of the many and varied issues legitimately in dispute.

The first, and basic, compromise is that with the Citibank consortium, the New Haven, and the United States, which had guaranteed $100 million of Trustees' Certificates. The second, and equally essential, compromise was with the multitude of state and local taxing authorities. Those authorities that did not choose to participate in an offer of early cash settlement are to be paid 44 percent of their claims in cash and early-maturing securities and the balance in notes.

In addition, the Plan reflects settlements with the "Friday Group," representing a large portion of the secured debt; with the active unsecured creditors; with Penn Central Company, the sole stockholder of Penn Central; and with the fifteen leased lines also in reorganization (the secondary debtors). The success of those compromise efforts is evident from the overwhelming votes of approval that the Plan has received.

A.

Pursuant to these compromises, the Plan accords secured claimants 10 percent in cash on consummation, general mortgage bonds in principal amount equal to 30 percent of the claim, preference stock with a redemption value equal to 30 percent of the claim, and new common stock worth 30 percent of the claim. This is referred to as the "10 triple 30" distribution. Approximately 55 percent of the new common stock in the reorganized company will be so disturbed to secured creditors.

The general mortgage bonds are in two series: A bonds, which are issued to a secured claimant in proportion to the extent his claim is secured by assets retained by the reorganized company, and B bonds, which in general represent the portion of the claim secured by assets conveyed to Conrail. A bonds are to be redeemed out of the asset disposition program ahead of B bonds, and B bonds are to be redeemed out of Valuation Case proceeds ahead of A bonds. Preference stock, which is to be redeemed from earnings of the reorganized company after 1980 and from proceeds of the Valuation Case, if sufficient, is also divided into Series A and B. Series A, which will be redeemed before Series B, will be issued to the supersecured creditors.

Unsecured claimants will receive 35 percent of the new common stock and Certificates of Beneficial Interest payable out of Valuation Case proceeds after senior obligations have been satisfied, to the extent of 30 percent of each claim.

The stockholder, Penn Central Company, will receive 10 percent of the new common stock.

B.

The Plans for the secondary debtors are, with certain exceptions, generally parallel to that of Penn Central.

Section 601(b)(4) of the RRRA transferred to the reorganization court all of the duties and responsibilities of the ICC as of April 1, 1976, when Penn Central transferred

its rail properties to Conrail. Subsequently, the reorganization court requested and received from the SEC a thorough analysis and approval of the Plan, and a further supplemental report approving amendments which had been proposed to the Plan, reflecting the settlement reached with the state and local taxing authorities. The reorganization court adopted in substantial part the findings of the SEC reports.

After full opportunity for hearing, the reorganization court approved the Plan (with certain minor amendments which have since been incorporated in the Plan) on March 17, 1978. Judge Fullam noted that "[l]ike all products of human endeavor, the Plan may not be perfect, but in my judgment it provides entirely fair and workable solutions to all of the complex and difficult problems confronting the Debtor's estate." On May 26, 1978, the United States Trust Company of New York, which had been designated by the reorganization court to conduct the voting on the Plan, reported that the Plans for the Penn Central and for fourteen of the fifteen secondary debtors were accepted by more than two-thirds of all classes. The fifteenth secondary debtor plan, that for the Pittsburgh, Fort Wayne & Chicago, was accepted by more than two-thirds of all classes except Class 0-2, representing the holders of common stock (54.2 percent).[21] The reorganization court confirmed the Plan pursuant to its power to do so under Section 77(e).

We turn, then, to the objections raised by the several appellants.

V.

Our review of the reorganization court's approval of the Plan is limited. In a reorganization case, as in any

21. For three security issues, two of the PFW&C and one of Penn Central, no valid ballots were cast.

appeal from a non-jury proceeding, we review for erroneous selection, interpretation or application of legal precepts, and for clearly erroneous findings of fact. *In re Chicago Rys. Co.*, 160 F.2d 59, 68 (7th Cir.), *cert. denied* 331 U.S. 808 (1947); *Comstock v. Group of Institutional Investors*, 163 F.2d 350, 357 (8th Cir. 1947), *aff'd.* 335 U.S. 211 (1948).

> It is not for us to pass upon the numerous factual and legal issues as though we were trying the cases *de novo*. "It is not enough to reverse the District Court that we might have appraised the facts somewhat differently. If there is warrant for the action of the District Court, our task on review is at an end." *Group of Institutional Investors v. Chicago, M., St. P. & P. R. Co.*, 318 U.S., at 564.

New Haven Inclusion Cases, 399 U.S. 392, 435 (1970); *see also In re Penn Central Transportation Co.*, 454 F.2d 9, 13 (3d Cir. 1972).

A.

None of these appellants attacks the basic structure of the Plan. They wish to stay within its existing framework, but seek to secure slightly better treatment than it presently affords. As we have noted, the Plan accommodates a complex series of compromises affecting the rights of numerous classes of claimants with various priorities of claims. Many of the compromise agreements will expire by their own terms if the Plan is not consummated in 1978. The complete collapse of the Plan, necessitating a return to the drawing board for a new plan, would place an even more crushing burden on the parties to this litigation. Judge Fullam's opinion accompanying the approval order thoughtfully and extensively analyzes the issues and

tribulations that will be avoided if the present Plan is effectuated.

The Plan classifies all claimants in fifteen categories, denominated Classes A through O. Appellants are pre-bankruptcy secured creditors, members of Class J, the tenth rank. Only the prodigious compromises affecting the nine higher classes render this plan feasible in any respect, and it must be emphasized that appellants challenge their treatment *within* Class J, not the ranking of Class J within the overall hierarchy created by the Plan. The appellants ask that we apply the absolute priority rule, *Northern Pac. Ry. v. Boyd,* 228 U.S. 482 (1913); *Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R.*, 318 U.S. 523, 542 (1943), as we must, but that we interpret it differently than did the reorganization court.

B.

The operative effect of the absolute priority rule is described in 6A Collier on Bankruptcy, Par. 11.06, at 210-11 (14th ed. 1977):

> Under the absolute priority rule, a plan is not "fair and equitable" unless it provides participation for claims and interests in complete recognition of their strict priorities, and unless the value of the debtor's assets supports the extent of the participation afforded each class of claims or interests included in the plan. Any arrangement by which a junior class receives values allocable to a senior class "comes within judicial denunciation." Beginning with the top-most class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate.

But this rule, as is the case of any legal precept, must be considered in the context of the facts at issue. The doctrine of precedent does not command that general rules, once properly determined, be applied blindly in later cases. As succinctly explained by Professor Edward H. Levi, "the scope of a rule of law, and therefore its meaning, depends upon a determination of what facts will be considered similar to those present when the rule was first announced. The finding of similarity or difference is the key step in the legal process." [22]

This court, as did the reorganization court, recognizes that no single precedent or group of precedents can provide precise guidance in this case because of the unique facts that have no precise counterpart in our legal tradition. The normal priority rules that apply to secured creditors must not be considered *in vacuo.* Throughout these proceedings, the absolute, or mechanical nature of orthodox rules of priority must always be viewed in accordance with the circumstances. The command of the rule must serve the reality of the fact.

And the brooding omnipresence that dominated the creation of the Plan, that permeated the jural atmosphere of the reorganization court, and is present here, is the recognition of fundamental, immutable facts: Penn Central's (1) monumental debt to the United States of more than a half billion dollars which has a statutory right to first priority on payment; (2) unpaid pre-petition taxes due state and local authorities; and (3) staggering administrative expenses. These massive claims all precede the demands of secured creditors. Because of such claims, the value of the collateral securing the claims of Class J creditors is relatively diminished. Our construction and application of precedents such as the absolute priority rule must

22. Levi, *An Introduction to Legal Reasoning,* 15 U. Chi. L. Rev. 501, 501 (1948).

necessarily take account of the unique facts of this Plan and proceed in an environment pervaded more by relativity than by absolutes.

VI.

We first address the question whether the Plan, in providing Series A preference stock to certain bondholders whose mortgage liens were recognized by the reorganization court to have somewhat superior coverage, the super-secured creditors, adequately provides for them.

A.

Irving Trust Company serves as trustee of two collateral trust indentures securing some $15 million principal amount of New York Central and Penn Central bonds due in 1990 and 1993. We will consider in this opinion Irving's appeals relating to these collateral trust indentures. Irving also appeals from the Plan's treatment of the Mohawk and Malone bondholders. That appeal is discussed in a separate opinion filed this date, the *Irving Trust and Bank of New York Appeals.*[23] To secure payment of the principal and interest on the New York Central and Penn Central bonds, Irving holds approximately 160,000 shares of the capital stock of the Pittsburgh and Lake Erie Railroad Company (P & LE). The bonds are further secured by over $8 million principal amount of New York Central Railroad Company Refunding and Improvement Mortgage 5% Bonds (R & I bonds).

PCTC's petition for reorganization constituted a default under the terms of the indentures which would have

23. Although this opinion adjudicates the claims presented by Irving Trust as Indenture Trustee for the New York Central and Penn Central bondholders, it will be necessary to address these same claims in the companion opinions filed today in the *Irving Trust and Bank of New York Appeals. See, inter alia,* Part I.B.

empowered Irving to dispose of the P & LE stock and the R & I bonds held as collateral and to apply the proceeds to discharge PCTC's indebtedness to Irving, were it not for the reorganization court's prohibition of such disposition by Order No. 1 entered on June 21, 1970. Pursuant to subsequent orders of the reorganization court, dividends paid on the P & LE stock have been utilized to pay a portion of the interest due Irving on the 1990 and 1993 bonds, so that there is presently about $700,000 unpaid interest.

The PCTC trustees have valued the P & LE stock at $100.15 per share, and expert testimony placed the value at $107.50 based on market quotations in May 1977, II, A-127. The outstanding $275 million of R & I bonds are secured by retained assets valued by the reorganization court at $99 million, giving the bonds a face value equal to 35.9% of their principal amount without making any allowance for an allocable portion of Valuation Case proceeds.

The foregoing figures support the reorganization court's finding that

> [t]wo collateral trust issues, the New York Central 6% bonds of 1990 (approximately 113% to 119% retained asset coverage) and the Penn Central 6½% bonds of 1993 (approximately 123% to 131% retained asset coverage), also have "super secured" status. In both cases, stock of the Pittsburgh & Lake Erie Railroad is the primary security.

I, A-1398 (footnote omitted).

Irving argues that the reorganization court erred in its treatment of the bondholders in two respects. First, the inclusion of *all* pre-bankruptcy secured creditors in Class J ignores "substantial differences in priorities, claims [and] interests" among the various creditors, in violation of Section 77(c)(7), 11 U.S.C. § 205(c)(7). Second,

despite the "super secured" status of the bondholders and their consequent preferential treatment, their compensation under the Plan is not the equitable equivalent of the rights surrendered and thus violates the Bankruptcy Act and the absolute priority rule.

B.

Title 11 U.S.C. § 205(c)(7) provides in pertinent part:

> (7) The judge shall promptly determine and fix . . . for the purposes of the plan and its acceptance, after notice and hearing, the division of creditors and stockholders into classes according to the nature of their respective claims and interests. Such division shall not provide for separate classification unless there be substantial differences in priorities, claims, or interests.

The last sentence of this provision was added as part of a 1935 amendment and was expressly intended to reverse the trend toward the recognition of many classes of creditors—particularly of secured creditors. *See* 79 Cong. Rec. 13764 (1935) (remarks of Senator Wheeler, sponsor of the statutory amendments); *id.* at 13298-99 (remarks of Rep. Summers, the House sponsor); Fuller, *Background and Techniques of Equity and Bankruptcy Railroad Reorganizations—A Survey,* 7 Law & Contemp. Prob. 377, 390-91 (1940) ("The amended statute was designed to discourage such over-classification."). The experience which contributed most significantly to the amendment was the Section 77 reorganization of the Missouri Pacific Railroad Company, in which the court designated 55 classes of creditors. Secured creditors were separately classified not only by mortgage, but by bond issue; at least one class consisted of a single creditor. The number of classes was later reduced to 24. *Missouri Pac. R.R. Co. Reorg.*, 239 I.C.C. 7, 28-32 (1940); *Missouri Pac. R.R. Co. Reorg.*, 290 I.C.C. 477, 482-83 (1954), *In re Missouri Pac. R.R. Co.*, 39 F. Supp. 436, 450 (E.D. Mo. 1941).

But even if secured creditors had been divided into separate classes as appellants argue should have been done, Section 77(e) requires only that the court

> is satisfied and finds, after hearing, that [the plan] makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan [otherwise satisfied the requirements of Section 77 (e), para. 1].

Any differences among the members of Class J are relatively insignificant, and under the applicable statutory test, should not result in the division of Class J into separate classes for voting purposes.[24] We hold that the court correctly declined to stratify the secured creditors into further minute categories based on a detailed examination of their collateral, and that the two objecting creditors had no right to separate classification.

C.

Supplementing the Fifth Amendment standard of just compensation as it applies in bankruptcy proceedings, *see*

24. Even if the contention of Irving were accepted, the results of the voting would not be any different for purposes of the confirmation of the Plan. If the four bond issues found by the reorganization court to be "super-secured" (Mohawk and Malone, the two P & LE Collateral Trust Indentures and the Gold Bonds) were considered to be a separate class, the results would be that 94 percent of those bondholders voting have accepted the Plan. Supplemental Report of United States Trust Co. dated June 8, 1978; Tables V-3, V-5, V-8, V-25, V-26 at 14, 16, 19, 36, 37.

In re Penn Central Transportation Co., 494 F.2d 270, 278 (3d Cir. 1974), are the statutory requirements of 11 U.S.C. § 205(e) (1), that a plan must be "fair and equitable" and must afford "due recognition to the rights of each class of creditors and shareholders," as well as the judicially created absolute priority rule. The rule is that "each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered. That requires a comparison of the new securities allotted to him with the old securities he exchanges to determine whether the new are the equitable equivalent of the old." *Group of Institutional Investors v. Chicago, M., St. P. & P. R. Co.*, 318 U.S. 523, 565-66 (1943). Irving contends that there is a "woeful inadequacy" in the value of its new securities under the Plan in comparison with the securities surrendered.

By applying record evidence as to the value of the securities in the 10 triple 30 distribution package, Irving asserts that the present value of those securities can be estimated to be between 44 and 58 cents on each dollar of its claim. In addition, although the surrendered P & LE shares pay dividends sufficient to service the interest requirements of the Irving bonds, the substituted 10 triple 30 securities, with the exception of the 10% cash payment, are non-income producing property. It is Irving's position that its treatment under the Plan squarely violates the following language of *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510, 527-29 (1941):

> The bondholders for the principal amount of their 6% bonds receive an equal face amount of new 5% income bonds and preferred stock, while the preferred stockholders receive new common stock. True, the relative priorities are maintained. But the bondholders have not been made whole. They have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of preferred stock, and their former strategic position has been weakened. Those lost rights are of value. Full compensatory provision must be made for the entire bundle of rights which the creditors surrender.
>
> . . . Thus it is plain that while creditors may be given inferior grades of securities, their "superior rights" must be recognized. Clearly, those prior rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. That is not permissible.

We note, however, that in the same opinion, the Court stated:

> The absolute priority rule does not mean that bondholders cannot be given inferior grades of securities, or even securities of the same grade as are received by junior interests. Requirements of feasibility of reorganization plans frequently necessitate it in the interests of simpler and more conservative capital structures. And standards of fairness permit it. This was recognized in *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445. This Court there said (p. 455) that though "to the extent of their

debts creditors are entitled to priority over stockholders against all the property" of the debtor company, "it does not follow that in every reorganization the securities offered to general creditors must be superior in rank or grade to any which stockholders may obtain. It is not impossible to accord to the creditor his superior rights in other ways."

Id. at 528 (footnote omitted). The Court provided further elaboration of the principles underlying application of the absolute priority rule at 529-30 (footnote omitted):

> Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. As indicated in the *Boyd* case (228 U.S. at p. 508) the creditors are entitled to have the full value of the property, whether "present or prospective, for dividends or only for purposes of control," first appropriated to payment of their claims. But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court.
>
> The Circuit Court of Appeals, however, made certain statements which if taken literally do not comport with the requirements of the absolute priority rule. It apparently rules that a class of claimants with a lien on specific properties must receive full compensation out of those properties, and that a plan of reorganization is *per se* unfair and inequitable if it substitutes for several old bond issues, separately secured, new securities constituting an interest in all of the properties. That does not follow from *Case v. Los Angeles Lumber Products Co., supra.* If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid. So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of "fair and equitable" are satisfied.
>
> Any other standard might well place insuperable obstacles in the way of feasible plans of reorganization.

Irving is not objecting to its treatment vis-à-vis the shareholders but to its treatment vis-à-vis other secured creditors. The reorganization court in this case did not err in limiting Irving's compensation to securities constituting an interest only in the properties as to which Irving's prior liens existed.

The Plan treats the claims of all Class J creditors as fully secured and gives all members of the class the same types of securities. The Plan's primary distinction among secured creditors is to award Series A general mortgage bonds for claims secured by retained assets and B bonds for claims secured by assets conveyed to Conrail. Series A bonds are to be redeemed with the proceeds of the already proceeding asset disposition program, whereas B bonds will be redeemed primarily with the proceeds of the Valuation Case. A secondary distinction has been created, however, which affects the priority of redemption of 30% of each claim—that which has been satisfied by preference stock. This stock, in a total amount of approximately $550 million, is to be redeemed from proceeds of the Valuation

Case and the profits of the reorganized company beginning in 1982; redemption priority is to be determined by lot. However, certain claimants, including Irving as indenture trustee for the New York Central and Penn Central bondholders, by virtue of their extraordinary strong security, were granted Series A preference stock which is to be redeemed in full prior to redemption by lot of the Series B preference stock. Because the A preference stock aggregates less than 10% of all the preference stock, its redemption is expected to be quicker and surer than that of the B preference stock. As a super-secured creditor, Irving thus receives significantly better treatment than other members of Class J, and we hold that equitable equivalence has been maintained.

D.

We readily acknowledge the unusually strong security underlying Irving's claim. But that strength is recognized and compensated by Irving's classification as a super-secured creditor and its receipt of Series A preference stock. We cannot accept, however, Irving's contention that it is "secured by a pledge of stock which is not subject to any conflicting claims or liens." Brief of Appellant Irving Trust Company, as Indenture Trustee, at 31. What this argument fails to recognize is the unfortunate reality that there is *nothing* in the debtor's estate which is not subject to any conflicting claims or liens.

Nine classes of claimants precede the pre-bankruptcy secured creditors. At least a billion dollars of higher priority claims prime the claims of the secured creditors, including those of Irving.[25] If there is now no "conflicting claim or lien" against the P & LE stock, it is because the

25. For a detailed discussion of the impact of these administrative claims, *see Irving Trust and Bank of New York Appeals* filed this date, Part I.B. 3.

highest priority creditors have compromised their claims for truly monumental debts. Needless to say, Irving does not object to those accommodations. Yet the same treatment of Irving's claim appears to be unsatisfactory. At bottom, Irving's attack on the "fair and equitable" nature of its compensation under the Plan must fail because it assumes that the value of the pledged securities prior to reorganization equals the face value of the P & LE stock and the R & I bonds. Proceeding from that premise, it is evident that Irving's new securities in the 10 triple 30 package have a lower present value than the surrendered securities. But what is being surrendered by Irving is not the face value of those securities—it is that value less whatever might be taken by the government and the myriad other prior claimants if this Plan were to fail and if every litigable claim were to be contested to its fullest extent.

Even if we accept Irving's valuation of its new securities as being worth approximately 50 cents on each dollar of its claim, it does not follow that Irving is receiving half of what it is surrendering. The interest of Irving in the surrendered P & LE stock and the R & I bonds cannot be equated with the full face value of those securities; the value of Irving's interest must be reduced by the vulnerability of the securities to prior administration claims. It is impossible to place an exact dollar amount on the value of Irving's interest, but in deciding whether Irving's compensation was "fair and equitable," the reorganization court correctly considered the relevant legal criteria. As in assessing the fairness of a compromise, *see Protective Committee v. Anderson*, 390 U.S. 414, 424 (1968), the reorganization court apprised itself of all facts necessary to form an intelligent and objective opinion of the probabilities of ultimate success should the claims be litigated,

and estimated the complexity, expense and likely duration of such litigation, and other factors relevant to a full and fair assessment of the securities. These are considerations directly affecting the worth of Irving's interest in the collateral securing the indentures. Although they cannot be quantified with any exactitude, the threats of invasion by nine classes of higher prior claimants shroud Irving's "super" security. After a full discussion of the foregoing considerations, the court concluded that Irving's argument

> focuses upon the uncertain value of the proposed new securities, but . . . assumes that [its] own claims are unassailable. This results in a distorted comparison between the claims surrendered and the benefits which would be received. . . . This argument assumes all of the benefits of the Plan (the compromises with the Government, the bank group, the New Haven Trustee, and the taxing authorities) for purposes of valuing the claims at full value, but assumes that the Valuation Case will make no contribution whatever to the value of the common stock of the reorganized company. . . . [Irving's argument] presents the same question under a different guise, namely, should a plan be attempted now, or should the results of the Valuation Case be awaited? This is perhaps the only question as to which there appears to be unanimous agreement: Everyone, including the super secured claimants, recognizes the desirability of achieving a plan now, rather than awaiting further developments.
>
> Thus, the immediate issue is whether the risks, uncertainties and possible benefits of the Valuation Case litigation, and the consequences of the RRRA process, are being fairly apportioned in the distributions proposed in the Plan. I am satisfied that the allocations are fair and equitable.

I, A-1408-09. We, too, are convinced that the bondholders represented by Irving are fairly and equitably compensated under the Plan. The value of their interest in the surrendered securities is substantially reduced by potential litigation of prior claims; the securities they will receive in the 10 triple 30 package enhanced by super secured status sufficiently compensate them for what is due under the mandate of the absolute priority rule.

VII.

Three other appellants, also pre-bankruptcy secured creditors who are members of Class J, challenge their treatment under the Plan, contending that the 10 triple 30 distribution package is not the fair and equitable equivalent of the securities they will surrender if the Plan is consummated. These appellants are the Wilmington Trust Company, the Manufacturers National Bank of Detroit and Charles S. Jeffrey. We will first outline the interests and claims of the appellants separately, and then, because of the substantial identity of the issues they raise, address the issues as they relate to the appellants collectively.

Wilmington is trustee for the Michigan Central Collateral Indenture (MCC indenture) secured by stock of the Michigan Central Railroad Company and by a second lien on Park Avenue properties. The face value of Wilmington's claim is presently \$21.8 million including principal and interest. This claim is secured by the pledge of 168,000 shares of Michigan Central stock, valued by PCTC trustees and the reorganization court at \$25.2 million, I, A-1398. As additional security for the MCC indenture, Wilmington shares with Manufacturers a second lien on the Park Avenue properties. The Park Avenue properties are valued at \$236 million; after satisfaction of the prior Gold Bond mortgage, there are some \$139 million of re-

tained assets securing Wilmington's and Manufacturers' combined $41.6 million claim.

Nevertheless, Wilmington is not classified as a super-secured creditor, because for purposes of super-security, the Plan recognizes only first liens. The result is that although the Park Avenue properties are worth $236 million, subject to the Gold Bond mortgage of $97 million, the "excess" value of $139 million is not marshalled down to second-level indentures for the purpose of awarding Series A preference stock as super-secured creditors. In the allocation of preference stock, only Wilmington's first lien on the MCC stock merits consideration, so Wilmington's security is only slightly greater than 100% and Wilmington's distribution under the Plan is Series B preference stock.

Anomalously, however, the Plan distributes Series A or B general mortgage bonds based only on the distinction between whether a claimant's securities are among the assets retained by the reorganized company or whether the assets were conveyed to Conrail. This part of the distribution takes no account of the amount or strength of the underlying security; for distribution of general mortgage bonds, all Class J creditors are treated as fully secured, and the only inquiry is whether the assets were retained or conveyed.

Thus, Wilmington is in no better position in the allocation of general mortgage bonds than a creditor whose very weak securities were retained, and for the allocation of preference stock, Wilmington fares worse than some claimants with far less total security merely because part of Wilmington's claim is secured by a second lien—regardless of the fact that the first lien leaves a huge excess of value that could be applied to Wilmington's claim. In short, Wilmington claims that although the securities available under the Plan are appropriate, the formula used to allocate those securities does not adequately distinguish the relative positions of the creditors and is thus not fair and equitable. Wilmington contends that its compensation should consist of 10% payment in cash and 90% payment in Series A bonds.

Manufacturers Bank is trustee for the Lake Shore Collateral Indenture which has a claim in the face amount of $19.8 million. Part of the security for this indenture consists of operating rail assets which were conveyed to Conrail. In addition to the conveyed assets, however, Manufacturers' indenture is jointly secured with the MCC indenture by a second lien on Park Avenue properties and other retained assets with a combined value of more than $300 million. Because the first lien on these properties is only around $100 million, the combined $41.6 million claims under the MCC and Lake Shore indentures are secured by the remaining $200 million value of these retained assets. Manufacturers thus asserts the same inequity urged by Wilmington based on the Plan's method of allocation of general mortgage bonds and preference stock. Manufacturers seeks payments of 10% in cash, 60% in A bonds and 30% in new common stock. It asserts a right to an extra 30% of A bonds rather than preference stock because the 10 triple 30 distribution package fails to differentiate among the various priorities of liens against retained assets which secure the claims of various creditors. Its high priority claims should result in new securities with high priority redemption, rather than the standard package distributed to Class J claimants in general.

Appellant Jeffrey is an individual holder of $204,000 in Michigan Central bonds. His claim is identical to that of Wilmington in all material respects, Brief of Appellant Charles S. Jeffrey at 12-13.

These appellants contend that the Plan is not fair and equitable as applied to them. They base their argument

on case law requiring certain factual findings which were not made by the reorganization court. In part, they challenge the findings of fact which were made. They challenge the logic employed by the reorganization court in analyzing the various claims of the secured creditors, urging that various alternative approaches to the analysis of competing claims would be more appropriate and would require that they receive better treatment. They suggest that the 10 triple 30 package does not adequately differentiate between junior and senior creditors, in effect arguing that the Plan must have more than the present number of creditor classes. Finally, and alternatively, they claim entitlement to super-secured status as a minimal recognition of the superiority of their security in comparison to other members of Class J. Without some readjustment of the Plan to reflect the strength of the collateral securing their claims, they insist that the Plan fails to satisfy the statutory and equitable mandates governing reorganization proceedings.

A.

Various aspects of the Plan which are under attack by these appellants have already been discussed at length. Assumptions basic to the Plan are: that the Valuation Case will produce a recovery sufficient to satisfy the claims of all secured creditors; that the far-reaching compromises of the highest priority creditors are fair and equitable and work to the benefit of all creditors; that it is impossible to place a dollar value on the outcome of the Valuation Case; that in the absence of the compromises embodied in the present Plan, there is no claim which is not subject to dispute which could only be resolved by lengthy and expensive litigation; that to effectuate a plan now is in the best interest of all claimants.

We have emphasized the unique nature of this proceeding. There are two faces to this consideration. First, every railroad reorganization is unique; the proceedings are equitable in nature and peculiar problems and claims invariably demand the attention of a reorganization court. Beyond the statutory requirement that a plan of reorganization be fair and equitable, there is little that may be regarded as absolute in the law governing railroad reorganizations. For example, we have alluded to the relativity demanded in applying the absolute priority rule. We decline to adopt a mechanical application of any of the embellishments, clarifications, extensions, derivatives or offshoots of the rule which have been so strenuously urged by the appellants.

Recognizing the equitable considerations and unique problems inherent in all reorganization proceedings, we are compelled to observe that some reorganizations have more specialized characteristics than others. Distinguishing this proceeding from all prior cases are a number of factors which require careful analysis in order to determine the weight and effect to be given to pronouncements of prior courts in bankruptcy cases. For one thing, there are no prior cases wherein a national transportation crisis led to a congressional mandate that the debtor continue operation long after it became obvious that it could not successfully reorganize, leading in turn to the creation of a special court to determine the extent of unconstitutional erosion of the estate caused by the mandatory deficit operations. Nor are there prior cases in which similar policies regarding the national transportation system led Congress to require the conveyance of a huge bulk of property without any prior evaluation, necessitating the special court to determine its value after the conveyance, in litigation expected to require ten more years. The sheer size of the expenses of administration, the unprecedented scope and number of compro-

mises preceding adoption of the Plan, and legislative intervention are all factors which require a unique approach to the weighing of the equities underlying the claims against PCTC.

B.

Appellants argue that *Consolidated Rock Products Co. v. Du Bois, supra,* 312 U.S. at 527-28, requires that a value be placed on the rights surrendered as the first step in determining whether the securities allocated under the Plan are the equitable equivalent of the old. They also state that the court erred in failing to apply marshalling principles to their collateral in order to ascertain the value of the rights they surrender under the Plan. Similarly, it is argued that the court erred in treating all Class J creditors as fully secured. Admitting the impossibility of anticipating the ultimate award which will eventually emanate from the Valuation Case, appellants contend nevertheless that a present value may be assigned to the securities representing the proceeds of the Valuation Case, that expert testimony of that value was presented to the court, and that the court was required to make a finding of the value but erroneously failed to do so. Finally, appellants challenge their exclusion from the group of super-secured creditors who are entitled to receive preferential treatment in the allocation of preference stock.

Initially we note that *Consolidated Rock, supra,* does not establish a *per se* requirement that a monetary value be placed on the rights surrendered by a creditor in a reorganization.

> It is said that *Consolidated Rock Co. v. Du Bois,* 312 U.S. 510, forbids the substitution of an approved capital structure for determinations of value. In that case there was no finding of the values of the property involved and this Court said: "Absent the requisite valuation data, the court was in no position to exercise the 'informed, independent judgment' (*National Surety Co. v. Coriell,* 289 U.S. 426, 436) which appraisal of the fairness of a plan of reorganization entails," page 520. . . . There is nothing, however, in the *Du Bois* case to indicate that dollar valuations of the property or claims are essential for recapitalization or the distributions of securities in reorganizations. The defect in *Du Bois* was not the failure to find dollar values but the failure to find the worth of the security behind independent mortgages on distinct properties and of assets subject to the claims of particular groups of creditors. Such findings were required in that case because the court was dealing with a parent and two subsidiaries with inter-company accounts. Each subsidiary entity had its own creditors. The system was a unified operation and we held the claims against the subsidiaries had priority over stockholders equity in the parent, p. 523. Without a separate valuation of assets, it was impossible to tell what assets of the parent were left to form the basis for the securities distributed to the parent's stockholders. In *Du Bois,* as here, the manner of reaching that valuation, so long as it complies with the statutory standards, is not important. There are subsidiaries here but there are no claimants of the subsidiaries looking to the parent. The aggregate of the authorized securities in the present case is to be equitably distributed among claimants against a single corporation. Findings were made as to the property covered by the different mortgages of the debtor and securities allocated on the basis of that finding. . . . Under such circumstances the lack of a valuation in dollars is immaterial.

Ecker v. Western Pacific R.R., 318 U.S. 448, 482-83 (1943) (citations omitted). The Court further elaborated on the

requirements of valuation in applying the absolute priority rule:

> But at any rate, under the absolute priority rule . . . the stratification of securities issued to creditors need not follow invariably the relative priority of the claimants. Apropos of a somewhat similar situation, we said in *Consolidated Rock Co. v. Du Bois,* 312 U.S. at p. 530:
>
> "If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid. So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of 'fair and equitable' are satisfied."

Id. at 484 (footnotes and citations omitted). We take this to mean that the necessity of placing a dollar amount on a creditor's collateral, as well as the securities substituted therefor, are matters to be determined under the circumstances of each case.

In this reorganization, placing a value on the rights surrendered by appellants is impossible. The securities they hold can be evaluated, but their vulnerability to prior administration claims would require the extensive, destructive litigation the reorganization court has sought so assiduously to avoid. Without the Plan, there would be no reorganization. Liquidation of retained assets would take years or decades; allocation of administration expenses would be disputed at every juncture; interest on prior claims would soar into the hundreds of millions. These facts are not denied by appellants. They recognize their benefit from the implementation of *some* plan now. They simply seek somewhat stronger substitute securities than the 10 triple 30 package affords. Thus they presented their "best case" and "worst case" analyses, their liquidation analogies and their alternative disposition schemes, all of which were considered by the reorganization court. The result is that they failed to establish their entitlement to better treatment, and their presentation of the same arguments to this court is no more convincing.

Appellants refer to their "seniority" as secured creditors. Their position is that, under any set of circumstances, their claims would be paid in full out of retained assets. Wilmington Brief at 26; Manufacturers Brief at 30. The reorganization court's opinion treats this contention in great detail at A-1397 through A-1407 and we are satisfied that it was correctly rejected. The reorganization court had good reason to place all secured creditors in Class J. With nine classes of prior claimants, and every asset of the debtor subject to unpredictable prior claims, there is no way to establish the relative priorities of the secured creditors without litigation of every potential claim. In short, what appellants seek is the benefit of every compromise which makes the Plan possible without accepting any of the burdens. They seek an ex parte determination of all litigable claims in order to establish their right to better treatment.

We find no error in appellants' exclusion from the group of super-secured creditors. Their principal argument is that the excess value of assets securing first liens on retained property should be marshalled down to subsequent liens for the purpose of determining super-security. Aside from the conceptual difficulties engendered by adopting this approach, the suggested revision would defeat the purpose of the recognition of super-secured status.

There is a logical inconsistency in finding the first lienor, the Gold Bond mortgage, with a claim of \$97 million secured by assets of \$236 million, to be 243% secured,

then to apply marshalling principles to the $139 million excess in order to evaluate the claim of the second lienor. In this case, the $139 million excess would render appellants 394% secured, but that would leave the first lienor only 100% secured. Similarly, the excess value which appellants want to use to establish their super-security would have to be marshalled down to third lienors, leaving appellants only 100% secured.

More fundamentally, the problem with the approach is that the court granted this preferential allocation of stock to the small group of recipients precisely because of the uncertainty of the contingent aspects of this reorganization. A "worst case" liquidation analysis suggests the possibility that only first lienors secured by assets substantially in excess of 100% of their claim would be fully compensated. In such an eventuality, there would be no excess assets to secure the claim of the holder of a second lien. The concept of marshalling in this limited context is therefore inappropriate because the minor preference granted the super-secured creditors exists solely to recognize their unique position—which is not shared by holders of subordinate liens.

We hold, therefore, that the reorganization court correctly found the compensation of appellants under the Plan to be the equitable equivalent of the rights surrendered, after an informed evaluation of the reasonable range of potential litigation possibilities affecting appellants' rights in their collateral.

VIII.

Our final appeal is that of the Erie and Kalamazoo Railroad Company (E & K).[26] In contrast to the other

26. The Clerk was informed by letter of May 26, 1978 that the Mahoning Coal Railroad Company and the Mahoning and Shenango Valley Railway Company (collectively, Mahoning), appellants in No. 78-. '11, intended to file a joint brief with E & K, appellant in

appellants, E & K does not challenge its treatment under the Plan—it objects to the Plan's failure to make any provision with respect to its administration claim. Because we find no error in confirmation of the Plan notwithstanding its exclusion of E & K, we affirm.

E & K is one of several non-bankrupt independent railroad companies which leased lines to Penn Central prior to reorganization. E & K filed a claim against the debtor for the use and occupancy of its properties during the period of reorganization in the amount of $496,000, a claim which, if allowed by the court, would be treated as a Class G administration claim. In contrast to the leased lines in bankruptcy, the secondary debtors, and other non-bankrupt leased lines which are subsidiaries of Penn Central, the Plan makes no specific provision for the independent non-bankrupt lines like E & K. Rather, it contemplates resolution by settlement or future adjudication by the reorganization court; because of pending settlement negotiations between the PCTC trustees and representatives of the leased lines, and because of difficult legal issues implicated by the leased lines' claims, the court deemed it preferable to proceed with the Plan now and to save resolution of these claims for another day. It did so on the understanding that

> the Plan would [not] be impaired by the failure of the non-bankrupts to join in the Plan. The Trustees have offered evidence that the feasibility of the Plan would not adversely be affected by the failure to have these

26. (Cont'd.)
No. 78-1710. Mahoning's subsequent motion for exemption from the briefing in light of a potential settlement agreement was granted on June 21, 1978. E & K filed its brief independently, and Mahoning never filed a brief. Mahoning is also a non-bankrupt lessor to the Penn Central; thus we believe its objections to the Plan are adequately addressed in this section.

> matters resolved before consummation, and no one has challenged that conclusion.

I, A-1366. The court noted that "the eventual resolution of the disputes between the reorganized company and the non-bankrupt lessors may be either more or less favorable to the Trustees" than the terms on which the Plan resolves the claims of the secondary debtors and the subsidiary leased lines. *Id.*

Most leased lines, including the bankrupts and subsidiaries, had claims against the estate which were offset by cross-claims for operating losses during the period of reorganization. In most instances involving lines which have been included in the Plan, resolution of the conflict involves mutual cancellation and discharge of the claims and cross-claims with some individual adjustments related to tax liabilities, bond claims and other factors differing as to specific leases.

The claim of E & K is also countered by the trustees' claim for operating losses, and negotiation of the claims has failed to reach settlement. Thus, under the terms of the Plan, E & K may continue to negotiate with the trustees, or it may seek adjudication by the reorganization court, and the resolution of the dispute "may be either more or less favorable" than those of the other leased lines.

A.

E & K asserts that the Plan is not fair and equitable because it discriminates against E & K in failing to resolve its claim while including provisions governing other leased lines. It argues that it is injured by the Plan's failure to reserve securities to satisfy its claim, should the claim ultimately be allowed by the court. By contrast, in those instances where the Plan calls for substantial consideration to be awarded to certain leased lines, Section 10.3 of the Plan requires that:

> The Reorganized Company will reserve for issuance, in accordance with the terms of the Plan . . . the maximum amounts of securities required . . . .

Appellant argues that such discrimination is without basis in the record and is not predicated on "substantial differences in priorities, claims, or interests" as required by 11 U.S.C. § 205(c)(7). In addition, it asserts that it was denied its right to a hearing on its objections in violation of 11 U.S.C. § 205(e).

Appellant's second major argument is that the Plan violates the absolute priority rule which requires that "senior claims *first* receive securities of a worth sufficient to cover their face and interest *before* junior claims receive anything." *Ecker v. Western Pacific R.R., supra,* at 483 (emphasis added). Because E & K's claim, if allowed, would be a Class G administration claim, it argues that it must receive recognition prior to the satisfaction of junior claims.

B.

We do not agree that the Plan unfairly discriminates against E & K. The record is clear that different factors justify different treatment of independent non-bankrupt lessors than is accorded the secondary debtors and the lines owned by the PCTC. It was essential that the Plan deal conclusively with the latter claims because they had a significant effect on the capital structure of PCTC. The same is simply not true of independent claimants whose claims may be satisfied in money or securities of the reorganized company. Nor do we share E & K's concern that there was no explicit reservation of securities to sat-

isfy its claim. The claim, if allowed in full, is less than a half million dollars; we note that that amount may be partially or entirely offset by the trustees' cross-claim. In the context of this multi-billion dollar reorganization, we think it self-evident that "the feasibility of the Plan would not adversely be affected by the failure to have these matters resolved before consummation." Having found no unfair discrimination against E & K, we cannot accept its argument that it has been divided into a "separate classification" without "substantial differences in priorities, claims, or interests" in violation of 11 U.S.C. § 205(c)(7). To the extent its claim is allowed, it will be classified in one of the existing classes of creditors. Finally, the assertion that the Bankruptcy Act was violated by the court's failure to hold a hearing on E & K's objections to the plan is likewise without merit. Title 11, U.S.C. § 205(e) requires a hearing prior to approval of a plan if a party in interest files objections to the plan. E & K was entitled to participate in the extensive hearings on the objections to the plan; indeed, counsel for E & K acknowledged that the trustees "encouraged" E & K's participation. Vol. V, A-106. That E & K's position was not adopted by the court or implemented in the plan is not equivalent to a failure to conduct the statutorily required hearings.

Accepting E & K's premise that its claim is an expense of administration which remains unsatisfied while the claims of junior creditors have been paid pursuant to the consummation order, we nevertheless perceive no violation of the absolute priority rule. Appellant's characterization of the rule as a temporal concept is not helpful. What is required is that provision be made for satisfaction of senior claims prior to satisfaction of junior claims; clearly it is immaterial in what order creditors physically receive their compensation under the plan. So long as the Plan provides sufficient flexibility to satisfy whatever portion of appel-

lant's claim as is ultimately approved, the absolute priority rule is not offended. The trustees concede and the court recognizes that appellant's claim must be resolved, that it must be classified, and that it must be satisfied in accordance with the appropriate classification. What is relevant here is that the disputed claim is so small in comparison to the size of the debtor's estate that it borders on the absurd to suggest that the Plan cannot incorporate whatever portion of the claim may be adjusted to be valid.

Accordingly, we reject appellant's contentions that the Plan is not fair and equitable and that it violates the absolute priority rule.

IX.

Henry Thoreau, in another context, observed that "[w]e do not ride on the railroad; it rides upon us." [27] It may be that many Penn Central creditors now share that view.

Nevertheless, as to these appellants we find no error of law or clearly erroneous findings of fact that would justify reversals of the orders of the reorganization court. As Judge Fullam stated, the Plan is a "monumental achievement," I, A-1456, "an important milestone in the long and tortuous struggle" to reorganize the embattled Penn Central, *id.* We agree with the reorganization court that the Plan provides entirely fair and workable solutions to the complex and difficult problems confronting the debtor's estate. Accordingly, we will affirm the orders of approval, confirmation and consummation of the Plan.

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27. H. Thoreau, *Walden*, Ch. II, Where I Lived, and What I Lived For (1854).

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1698, 78-1699, 78-1700, 78-1702, 78-1703, 78-1710, 78-1711, 78-2311, 78-2312, 78-2314, 78-2315, 78-2319 and 78-2320

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

MANUFACTURERS NATIONAL BANK OF DETROIT, Indenture Trustee under the Lake Shore Collateral Indenture,

Appellant in No. 78-1699
(Appeal from D.C. Order No. 3455)

Appellant in No. 78-1700
(Appeal from D.C. Order No. 3456)

Appellant in No. 78-2315
(Appeal from D.C. Order No. 3707)

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

Wilmington Trust Company, as Successor Indenture Trustee under the New York Central and Hudson River Railroad Company, Michigan Central Collateral Indenture dated April 13, 1898

Appellant in No. 78-1703
(Appeal from D.C. Order No. 3455)

Appellant in No. 78-2311
(Appeal from D.C. Order No. 3707)

Appellant in No. 78-2312
(Appeal from D.C. Order No. 3708)

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

Charles S. Jeffrey, a holder of The New York Central and Hudson River Railroad Company 3½% Michigan Central Collateral Bonds,

Appellant in No. 78-1702
(Appeal from D.C. Order No. 3455)

Appellant in No. 78-2319
(Appeal from D.C. Order No. 3707)

Appellant in No. 78-2320
(Appeal from D.C. Order No. 3708)

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

Erie and Kalamazoo Railroad Company,

Appellant in No. 78-1710
(Appeal from D.C. Order No. 3455)

Submitted Under Third Circuit Rule 12(6)
October 16 and 17, 1978

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

Irving Trust Company, as Indenture Trustee,

Appellant in No. 78-1698
(Appeal from D.C. Order No. 3455)

Appellant in No. 78-2314
(Appeal from D.C. Order No. 3707)

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

The Mahoning Coal Railroad Company and
The Mahoning and Shenango Valley Railway Company,
Appellants in No. 78-1711
(Appeal from D.C. Order No. 3455)

(D.C. No. B-70-347 In Bankruptcy)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Present: ALDISERT, GIBBONS and HIGGINBOTHAM,
Circuit Judges

JUDGMENT.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the orders of the said District Court of approval, confirmation and consummation of the Plan at district court numbers 3455, 3456, 3707 and 3708, be, and the same are hereby affirmed. Costs taxed against appellants.

ATTEST:

THOMAS F. QUINN,
Clerk.

January 11, 1979

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1692, 78-1693, 78-1694, 78-1698, 78-1716,
78-2314, 78-2316, 78-2317, 78-2318

IN THE MATTER OF:
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

The Bank of New York, as successor trustee under The New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage dated October 1, 1913

Appellant in Nos. 78-1692, 78-1693, 78-1694,
78-2316, 78-2317 and 78-2318

The Irving Trust Company, as Indenture Trustee,
Appellant in Nos. 78-1698 and 78-2314

Harriet Signer; Seymour Gillman; Anne Frank; McMaster Holding Co.

Appellants in No. 78-1716

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA
(D.C. No. B-70-347 In Bankruptcy)

Argued October 16 and 17, 1978

Before: ALDISERT, GIBBONS and HIGGINBOTHAM,
Circuit Judges

(Opinion filed January 11, 1979)

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OPINION OF THE COURT

GIBBONS, *Circuit Judge*

We deal in this opinion with appeals by two indenture trustees, representing four secured bond issues, from orders of the district court approving and confirming the Amended Plan of Reorganization of Penn Central Transportation Company (PCTC or the Debtor) and related debtors in reorganization under § 77 of the Bankruptcy Act, 11 U.S.C. § 205.[1] Judge Aldisert's opinion in *In re Penn Central Transportation Co. (Reorganization Plan Appeals)*, Nos. 78-1698/1700, 78-1702/03, 78-1710, 78-2311/12, 78-2314/15 and 78-2319/20 (3d Cir. January 11, 1979), filed simultaneously herewith, rejects challenges by other secured creditors to the Plan of Reorganization. Reference is made to that opinion for an account of the history of the proceedings, and a description of the debtor

1. *In re Penn Central Transp. Co.*, 458 F. Supp. 1234 (E.D. Pa. 1978) (*Approval Opinion*); *In re Penn Central Transp. Co.*, 458 F. Supp. 1364 (E.D. Pa. 1978) (*Confirmation and Consummation Opinion*). Unless otherwise noted, all citations herein are to the *Approval Opinion*.

estates, the structure of the Plan, and the legal justifications for that structure. Judge Higginbotham's opinion in *In re Penn Central Transportation Co. (Stockholder Appeals)*, Nos. 78-1715, 78-2321, and 78-2336 (3d Cir. January 11, 1979) rejects challenges to the Plan made on behalf of shareholders in the Penn Central Company, the Debtor's sole stockholder.

This opinion considers specific objections to the treatment of certain secured creditors.[1a] The Irving Trust Company is indenture trustee under a Collateral Trust Indenture dated April 15, 1965 made by New York Central Railroad Company (a predecessor of the Debtor) securing a claim of $7,800,000 principal amount of New York Central 6% bonds due April 15, 1990 (the New York Central 6's). It is also trustee under a Collateral Trust Indenture dated April 15, 1968 made by Penn Central Company (a predecessor of the Debtor securing a claim of $7,641,800 principal amount of Penn Central 6½% bonds due April 15, 1993 (the Penn Central 6½'s). Finally, Irving Trust is successor indenture trustee under a First Mortgage dated July 1, 1892, made by The Mohawk and Malone Railway Company (a predecessor of the Debtor), which secures a claim of $1,489,000 principal amount of 4% Gold Bonds due September 1, 1991 (the Mohawk & Malone Bonds). Interest arrearages on the Mohawk & Malone Bonds total $478,000 as of December 31, 1977. The Bank of New York is successor indenture trustee under The New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage of October 1, 1913 (the R & I Mortgage). That mortgage secures a claim of $214,470,000, representing $125,351,000 4½% Series A

1a. Judge Aldisert's opinion contains a complementary discussion of the appeals filed by the Irving Trust as indenture trustee for the two Collateral Trust Bond issues.

Bonds and $89,119,000 5% Series C Bonds held by the public. Appellant Harriet Signer is a holder of R & I Bonds.

The indenture trustees representing these creditors do not object to the basic structure of the Plan of Reorganization, but only to the allocation of securities to them within that structure. The three Irving Trust issues—all of which were accorded "super secured" status in the final Plan—contend that the distributions proposed to be made to them under the Plan do not provide them with compensation that is the equitable equivalent of the well-secured claims that they will be required to surrender. Therefore, they contend, the Plan violates the rule of absolute priority, originally applied in diversity railroad equity receiverships, *Northern Pacific Ry. v. Boyd*, 228 U.S. 482 (1913), and subsequently in proceedings under § 77 as well. *E.g., Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R.*, 318 U.S. 523 (1943). The R & I bondholders' more modest assertion is that the proposed distribution to them is insufficient because of the Plan's failure to treat certain assets of the estate as properly subject to the lien of the R & I Mortgage. We will deal with these distinct contentions separately under the captions "I. The Irving Trust Appeals" and "II. The R & I Appeal." Our resolution of these issues, which requires some modification of the distributions to these appellants, does not affect the confirmation or consummation of the Plan.

I. THE IRVING TRUST APPEALS

A. The Factual Setting

1. *The Claims and Their Underlying Security*

The claims of the two Collateral Trust Bond issues,[2] although they differ slightly in their details, are essentially

2. Portions of this discussion parallel, in slightly greater detail, the account of the Collateral Trust claims contained in Judge Aldisert's opinion in the *Reorganization Plan Appeals*.

similar. The New York Central 6's have a claim of $7,800,000 principal amount. As of December 31, 1977, accrued unpaid interest on the bonds amounted to $332,000. That claim is secured by 78,000 shares of the capital stock of the Pittsburgh & Lake Erie Railroad Co. (P&LE) pledged under the Trust Indenture. The P&LE is an independent, profitable railroad, 92.61% of whose stock is held by the Debtor. None of the Debtor's P&LE stock was conveyed to ConRail pursuant to the Regional Rail Reorganization Act (RRRA). The Trustees treated the P&LE stock, for purposes of the Plan, as having a value of $100.15 per share, and the reorganization court, by confirming the Plan, implicitly approved that valuation.[2a] While there was conflicting evidence as to the value of the stock, we think that the Trustees' proposed valuation, approved by the reorganization court, is not clearly erroneous, and we adopt it here. In addition, the 6's are secured by $3,900,000 principal amount of R & I 5% Series C Bonds. In the Plan, these bonds are treated as secured by retained assets to the extent of 35.9% of their face amount. Based on these figures, the value of the retained asset security underlying the claim of the New York Central 6's is $9,211,800. Their ratio of retained asset security to secured debt is thus 113.28%.

The Penn Central 6½'s have a claim of $7,641,800 principal amount, and accrued interest as of December 31, 1977, of $353,000. The claim is secured by 83,698 shares of P&LE stock, and $4,185,000 principal amount of R & I 5% Series C Bonds. The value assigned this security under the Plan was $9,884,770, and the ratio of retained asset security to the total claim is 123.64%.

2a. Even if a higher value were recognized for the P&LE stock, our view is that the impact of potential priming claims is so substantial as to render immaterial any difference between the values proposed by Irving Trust and those proposed by the Trustees. *See* pp. 35-36, *infra*.

The Mohawk & Malone claim, including interest, totals $1,967,000. It was originally secured by all of the railroad's assets. In July, 1972, the Interstate Commerce Commission approved a petition by the Trustees to abandon the railroad's Lake Placid branch. In February, 1975, the State of New York condemned the abandoned line. Pending a final judicial determination of the condemnation award, the State of New York has paid over to the estate the sum of $3,900,000, representing its offering price less certain expenses. That sum, along with proceeds of sale of other encumbered assets, has been deposited in an escrow account which now totals $4,535,000. In addition the bonds are secured by other retained assets worth $850,000. Thus the total security for $1,967,000 is a first lien on $5,385,000 in assets. On the basis of escrowed cash alone this mortgage indenture is 230.55% secured. Counting other retained assets it is 273.77% secured.

2. *The Proposed Distributions Under the Plan*

As Judge Aldisert explains in greater detail in his opinion, the foundation of the Plan's distribution to secured creditors is the assumption that at the conclusion of the Valuation Case the estate of the Debtor will prove to be solvent. The Plan therefore treats each secured creditor as fully secured, regardless of the degree to which that creditor is secured by conveyed assets whose ultimate value to the estate is as yet undetermined. For every $100.00 of claim, each secured creditor receives a payment package consisting of 10% in cash, payable upon consummation, 30% in General Mortgage Bonds, 30% in Redeemable Preference Stock, and 30% Common Stock of the Reorganized Company.

Within this package, the Plan originally recognized the relatively stronger position of creditors fully or par-

tially secured by retained assets through its formula for the distribution of General Mortgage Bonds. The Bonds were divided into Series A and B. Within the 30% of the total distribution represented by the mortgage bonds, each secured creditor was awarded Series A Bonds in proportion to the degree that his claim was secured by retained assets of the Debtor. The remainder of the 30% was satisfied with Series B Bonds. Thus, for example, a claim 70% secured by retained assets would receive, for each $100.00 of claim, $21.00 in Series A Bonds and $9.00 in Series B Bonds. Beginning in 1981, both series of bonds will bear interest at an annual rate of 7%. Series A Bonds are to be redeemed out of the proceeds of the sale of the Debtor's marketable retained assets, upon which the Plan gives them a claim ahead of the claim of the Series B Bonds. The Trustees' cash flow predictions indicate that the proceeds from the sale of these retained assets should be sufficient to retire all outstanding Series A Bonds and 11.25% of the Series B Bonds by 1983, and to pay most of the interest on the Series B Bonds through 1987. The bulk of the Series B Bonds will, however, probably be redeemed principally out of the proceeds of the Valuation Case, in which their claim comes behind an estimated $1.278 billion of government and state and local tax claims. Series B Bonds not redeemed in the Valuation Case convert into Common Stock of the Reorganized Company. Series A Bonds come behind Series B Bonds in the Valuation Case. Series A Bonds that survive any shortfall in both the distribution from retained assets and the Valuation Case will remain as general obligations of the Reorganized Company.

Preference stock was originally proposed as a single issue to all secured creditors alike at a rate of 1.5 shares for every $30.00 of claim surrendered. Beginning in 1982, preference stock is redeemable out of the earnings of the

Reorganized Company at a price of $20.00 per share, provided that the Reorganized Company's consolidated net income exceeds $50,000,000 and sufficient cash is available to cover the redemption. Up to 5% of the total preference stock allocation may be retired each year in this fashion. If the income test is met, but no cash is available, the obligation to redeem will cumulate from year to year. The Trustees' figures show that the income test for redemption will be met in 1981, but there are no income or cash availability figures which would permit an educated estimate of the likelihood that preference stock will be redeemed from earnings in 1981 or in later years. Preference stock is also redeemable from the Valuation Case proceeds, with a claim subordinate to those of the federal government, the state and local taxing authorities, and the Series B and A Mortgage Bonds. Each share of preference stock has ⅔ of a vote in the shareholders' councils of the Reorganized Company. Any preference stock unredeemed at the end of the Valuation Case will convert to Common Stock in the Reorganized Company at the rate of one share of Common for every 6.5 shares of Preference Stock. Holders of preference stock also may, at their option, convert to common stock at the same ratio at any time prior to the close of the Valuation Case.

The Common Stock, which represents the last 30% of face amount of each secured creditor's claim, remains entirely at the risk of the reorganized enterprise. Its present value is low. Its future value depends largely upon the fulfillment of two uncertain hopes: first, that the Valuation Case recovery will be sufficient to satisfy the massive prior claims of secured and unsecured [3] creditors and to produce

3. Unsecured creditors receive Certificates of Beneficial Interest for 30% of their claims. These Certificates are redeemable out of Valuation Case proceeds after the Preference Stock. If not so redeemed, they will be cancelled. The remainder of each unsecured creditor's claim is reimbursed in Common Stock.

an additional large bonus for the equity; and second, that the Reorganized Company, its assets heavily encumbered with past claims, will earn enough to retire its senior debt securities and produce a substantial equity for stockholders.

In the version of the Plan originally presented to the reorganization court, no provision was made for any classification of secured creditors other than that afforded by the division of General Mortgage Bonds into Series A and B. Before that court, however, a number of representatives of secured creditors, including Irving Trust, protested the proposed Plan's allocation of securities as violative of the absolute priority rule. Their contention was that since the Plan purported to be a fair and equitable compromise of the disputes that would have arisen in a litigated liquidation of retained assets, the allocation of compensation under the Plan should provide recognition of the stronger position of those mortgage bonds which, by virtue of the depth or position of their security, could demonstrate that they were likely to be paid off in full at the close of such a liquidation.

The reorganization court recognized the force of this argument. Applying the standards for the evaluation of compromises announced in *Protective Committee for Independent Stockholders of TMT Trailer Ferry Association v. Anderson*, 390 U.S. 414 (1968), it concluded that no secured creditor was assured of surviving a litigated liquidation. It also concluded, however, that a handful of bondholders were significantly more secured by retained assets than others, were considerably more likely to emerge from a litigated liquidation with payment of all or nearly all of their claim in cash, and therefore merited more consideration than the Plan provided them. Referring to that group of creditors as "super secured," it wrote:

The foregoing discussion leads to the conclusion that, generally speaking, the "super secured" creditors as a group receive appropriate allocations of retained assets for purposes of the A-B bond distributions under the Plan. All have retained asset coverage in excess of 100% of the amounts of their claims, and the Plan accords the same treatment to all of these creditors. But while all of these creditors are on an equal footing, there is some merit in the suggestion that, in the vernacular, some are more equal than others. The Mohawk & Malone (011) mortgage has 275% retained asset coverage, and the Gold Bond Mortgage has 243% retained asset coverage. The New York Central 6% bonds of 1990 and the Penn Central 6½% bonds of 1993 have retained asset coverage of approximately 119% and 131% respectively, and they have the further advantage of the pledge of the Pittsburgh & Lake Erie stock. In my judgment it would be preferable to accord claimants under these four mortgages somewhat better treatment than the Plan provides, if that can be accomplished within the contours of the present Plan.

For the reasons discussed above, I am satisfied that no "super secured" claimant can properly lay claim to more cash or A bonds than the Plan provides. The alternative distribution scheme is invalid, and would not work. But within the framework of the present Plan, there is some room for flexibility in the handling of preference stock. Under the Plan, the selection of preference stock to be redeemed first is to be made by lot. While this is eminently fair as among holders similarly situated, it could, in actual operation, allow holders less favorably situated than the bondholders of these four mortgages to receive

> satisfaction of their claims before these more favorably situated bondholders. To prevent such an eventuality, in my judgment the solution is simply to include provisions guaranteeing that the holders of preference stock issued in exchange for the surrender of claims under the four mortgages listed above will have rights of redemption *pari passu* which take precedence over the redemption rights of other preference shares.

In re Penn Central Transportation Co., 458 F. Supp. 1234, 1302 (E.D. Pa. 1978).

The consequence of this decision was an amendment of the preference stock redemption features of the Plan. Two series of preferred stock were created, with Series A Preference Stock distributed to the four "super secured" creditors and Series B to all remaining creditors. As between the two Series, A Preference Stock has a first claim on both the income of the Reorganized Company and the proceeds of the Valuation Case. Since some redemption of some preference stock from the company's earnings is not unlikely, and since the relatively small amount of A Preference Stock ($34,300,000) will come ahead of all B Preference Stock ($533,900,000) in the Valuation Case, the value of the redemption preference afforded by classification in Series A is substantial. The three groups of bondholders represented by Irving Trust Company on this appeal were all designated as recipients of Series A Preference Stock. Thus, under the Plan, the three Irving bond issues each received a 10% cash distribution, 30% Series A Bonds, 30% Series A Preference Stock, and 30% Common Stock.

B. Analysis

1. *The Issue and the Standard of Review*

In a railroad reorganization the process of allocating the value of the debtor's estate to creditors is regulated by

the so-called absolute priority rule. *Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R.*, 318 U.S. 523, 546 (1943) *(Institutional Investors)*. The requirements of that rule have been precisely stated in 6A *Collier on Bankruptcy* ¶ 11.06, at 210-11 (14th ed. 1977):

> Under the absolute priority rule, a plan is not "fair and equitable" unless it provides participation for claims and interests in complete recognition of their strict priorities, and unless the value of the debtor's assets supports the extent of the participation afforded each class of claims or interests included in the plan. Any arrangement by which a junior class receives values allocable to a senior class "comes within judicial denunciation." Beginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate.

(footnotes omitted). The application of this rule to proceedings under § 77 of the Bankruptcy Act is widely recognized[4] and is not contested here.

The function of the absolute priority rule is two-fold. First, the rule is intended to assure that the investment securities distributed as compensation under the Plan have a value at least roughly equivalent to the value of the claim surrendered. The reviewing court is therefore required to make "a comparison of the new securities allotted to [the claimant] with the old securities which he exchanges to determine whether the new are the equitable equivalent of

4. *E.g., RFC v. Denver & R.G.W.R.R.*, 328 U.S. 495 (1946); *Institutional Investors, supra; Ecker v. Western Pacific R.R.*, 318 U.S. 448 (1943). The absolute priority rule also applies in proceedings under Chapter X of the Bankruptcy Act, and so cases decided under that statute are relevant here as well. *See Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467, 473 n.11 (1974).

the old." *Institutional Investors, supra,* 318 U.S. at 566. In addition, the rule commands that until senior creditors have received that "full compensatory treatment," *Consolidated Rock Products Co. v. DuBois,* 312 U.S. 510, 529 (1941), participation in the estate by junior creditors must be barred. *RFC v. Denver & R.G.W.R.R.,* 328 U.S. 495, 517 (1946); *In re Central Railroad Co. of New Jersey,* 579 F.2d 804, 810 (3d Cir. 1978). These standards of priority protect both the principal of and interest on the senior creditor's claim. *Institutional Investors, supra,* 318 U.S. at 546. They also shield a secured creditor's priority in his security up to the lesser of the full value of the secured assets or the full value of his claim. *In re Equity Funding Corp.,* 416 F. Supp. 132, 145 (C.D. Cal. 1975).

Strict application of the foregoing principles would require that the process of compensating creditors in the run-of-the-mill corporate reorganization under the absolute priority rule proceed after the fashion of a liquidation, and it is tempting to demand of the reorganization process the kind of mathematical exactness that would result in such a case. There are, however, two important distinctions between liquidation and reorganization. First, in a reorganization the aggregate value of the debtor's assets is determined, not by a judicial sale, but by a hypothetical—albeit expert—calculation of their future worth to the enterprise. Second, claimants are satisfied not with cash, but with securities which reflect an apportionment of value in an ongoing business enterprise. It has long been recognized that these features of the reorganization process make is wholly unreasonable to expect that any plan will meet with precision the standards of the absolute priority rule. In every reorganization, numerous difficult issues of valuation must be resolved. The pressure of time and circumstance and the inherent uncertainty of forecasting the future of the

enterprise seldom permit a certain determination of value.[5] On the distribution side, precise appropriation is necessarily handicapped by the recognized need to avoid overly elaborate and unstable capital structures.[6] These countervailing concerns find expression in the statutory requirement that reorganization plans must be "feasible", as well as "fair and equitable." Flexibility in the pursuit of feasibility has expressly been sanctioned by the Supreme Court:

> The absolute priority rule does not mean that bondholders cannot be given inferior grades of securities, or even securities of the same grade as are received by junior interests. Requirements of feasibility of reorganization plans frequently necessitate it in the interests of simpler and more conservative capital structures. And standards of fairness permit it.
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> . . . .
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> Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. . . . [W]hether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as the new securi-

5. *See Institutional Investors, supra,* 318 U.S. at 561-66; *cf. Nashville C. & St. L. Ry. v. Browning,* 310 U.S. 362, 370 (1940) ("[R]ailroads, unlike farms and city lots and stocks and bonds, are not objects of exchange. The very notion of a 'full cash value;' for a railroad is in many respects artificial . . . . Whatever may be the pretenses of exactitude in determining such a 'value' to claim for it 'scientific' validity is to use the term in its loosest sense." (citation omitted)).

6. *See Ecker v. Western Pac. R.R., supra,* 318 U.S. at 476; *Consolidated Rock Products Co. v. DuBois, supra,* 312 U.S. at 528.

> ties offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court.

Consolidated Rock Products Co. v. DuBois, supra, 312 U.S. at 528-30 (footnotes omitted). *Accord, Institutional Investors, supra,* 318 U.S. at 565-66. *Northern Pacific Ry. v. Boyd, supra,* 228 U.S. at 508.

The need for a pragmatic approach to the allocation of asset values was particularly great in this case. In any chapter proceeding, the practical problems of valuing the debtor's estate (and, more particularly, of valuing the assets subject to the liens of individual secured creditors) and of achieving a workable distribution to creditors are hard ones. In this case, those difficulties were many times compounded. Normally, the assets of the estate—encumbered and unencumbered—are in hand and readily subject to valuation by traditional methods. Here, as a result of the conveyance to ConRail under the RRRA, assets with a book value of $3.2 billion had passed from the estate prior to the preparation of the Plan. Many creditors of the estate were secured in substantial part by those assets. Any final determination of the value of these assets to the estate, and to the individual lienholders whose claims they secured, would have had to await the outcome of the Valuation Case now pending before the Special Court—a resolution optimistically predicted to occur in 1987.

Creditors whose claims were secured by retained assets had the advantage that their security could be more readily valued. But even for creditors whose claims are secured by retained assets with a readily ascertainable market value, difficult problems of valuation remained. The special strength of such claims lay in the creditors' ability to realize the full value of the security at an early date in a liquidation. In this case, however, both the amount and

timing of that realization were seriously in doubt. The prolonged deficit operations of the debtor had given rise to vast administration claims against the estate. Since by the terms of the conveyance to ConRail, the conveyed assets of the estate were transferred free and clear of all liens, these claims had been left behind to compete with those of the creditors secured by retained assets for the diminished portion of the Debtor's assets that remained. Thus, the $1,848,969,000 in retained assets of the Debtor and its subsidiaries (of which only $586,125,000 were unencumbered) were arguably called upon to answer approximately $1,000,000,000 in costs of administration. In consequence, the security of even the best secured retained asset creditors was at least arguably subject to invasion by priming administration claims. The extent of that potential invasion, however, turned on the resolution of a vast number of legal questions for which no precedent existed.

The Trustees faced a difficult choice. The only way to resolve these issues of valuation with precision would have been to litigate both the Valuation Case and the liquidation to a conclusion. It would in theory have been possible at the close of the Valuation Case to determine precisely the compensation awarded for each conveyed encumbered asset and to allocate that value to the appropriate mortgage interest. In the meantime, the distribution of the estate could have proceeded by means of an extended series of litigation in which the relative vulnerability of each security interest to claims of administration was finally determined in a court of law.

At the close of such a litigated liquidation, each secured creditor would have been granted a share of the debtor's estate precisely apportioned to the value of his security and reflecting a final judicial determination of his liability for administrative expenses. The cost of certainty, however, would surely have been very high. The reorgani-

zation court ably described the delay and confusion that would have attended such proceedings:

> In their evidentiary submission, the Trustees have spelled out in some detail the major sources of potential litigation. These include the disputes concerning the relative priority of governmental claims, state, local and federal; the validity of the Pennco pledge agreement; a host of issues concerning the coverages of various mortgages and the correct application of marshalling principles; and what is perhaps the most significant but least understood problem, unraveling the intricate relationships between the Debtor and the Secondary Debtors. And even if these disputes could be finally resolved through litigation by the early 1980s, as the Trustees assume, there is another aspect of the matter which the Trustees appear to have somewhat underestimated. All of these disputes are interrelated. Generally speaking, the highest-priority claims must be finally resolved before distribution to lower classes could be. For that reason, until the highest-priority claims are known, it is virtually impossible to determine correctly the treatment which lower classes of claims should receive. It is unlikely, therefore, that litigation of all of these major disputes could efficiently be pursued simultaneously. Stated otherwise, if the litigation proceeded simultaneously, it might well be necessary, upon completion of one round of litigation, to commence an entirely new round of litigation in order to determine how the results of the first round of litigation should be implemented (either in a Plan of Reorganization, or in the hypothetical liquidation distributions).
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> Until the validity and priority of the Government claims were finally determined through litigation, no distributions of any kind could be made. Until the issues surrounding the state and local tax claims were determined through litigation . . . , distributions to bondholders would seem unlikely. Perhaps more importantly, until the amount of the recovery in the Valuation Case became known, it would be impossible intelligently to work through the problem of allocating unpaid administration claims among the various mortgages, rendering distribution impossible. And until the Secondary Debtor issues were resolved, those assets would not be available for Penn Central creditors.

In re Penn Central Transportation Co., 458 F. Supp. at 1263-64. This delay might also have been accompanied by deletion of the estate. For example, any extended litigation ran the risk of tying up the liquidation of the marketable assets of the estate until after the expiration in 1983 of the Debtor's enormous tax-loss carry forwards—a crucial asset of the estate. And the cost of conducting litigation—both for creditors and for the estate—would surely have been enormous.

The alternative was a plan, like the one ultimately adopted, in which the uncertainties imposed by the Valuation Case and the impact of administration claims were compromised in order to make possible an early and certain payout to senior creditors. Judge Aldisert has capably described the major compromises—with the federal government, the state and local tax claimants, the Pennco pledgeholders, the New Haven Trustee and the Secondary Debtors—that underlie the Plan. It is important to remember, however, that the terms extended to the Debtor's public investor creditors under the Plan were also the result of negotiated compromises. Thus the allocation formula first proposed to be applied to all secured creditors under the Plan was the result of a negotiated compromise between the Trustees and a consortium of insti-

tutional investors representing holders of a large percentage of the publicly held secured claims against the debtor. Although the creditor appellants in the instant appeals were not parties to that compromise agreement, under the Plan its terms were extended willy-nilly to them as well. In similar fashion, the proposed allocations to unsecured creditors and the Debtor's principal stockholder, the Penn Central Company, both of which the appellant creditors in these appeals heatedly protest, also result from negotiated compromises. In view of the alternative, it is clear that these compromises benefited the estate as a whole, and secured creditors in general. It is a different question whether these compromises truncated, in procrustean fashion, the rights of these particular bondholders to protect their strong positions in a litigated liquidation.

Compromise of disputes as part of a plan of reorganization is one of the "[p]ractical adjustments" approved by the Supreme Court in *Consolidated Rock Products Co. v. DuBois, supra,* 312 U.S. at 529. The Court has recognized that "[i]n administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts." *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson,* 390 U.S. 414, 424 (1958) *(TMT Trailer Ferry).* The power to compromise is usually applied to claims belonging to the estate rather than to those of senior creditors like the Irving Trust bondholders. *E.g., TMT Trailer Ferry, supra; Consolidated Rock Products Co. v. DuBois, supra.* But since the terms upon which a major claim of a distressed estate is settled may often determine whether or not a given creditor class is able to participate in the estate at all, we can see no difference in principle that would forbid an enforced compromise of even the most senior of claims.

That a particular compromise may be necessary or desirable, however, does not eliminate the statutory requirement that the plan be "fair and equitable." 11 U.S.C. 205(e). Similarly,

> [t]he fact that courts do not ordinarily scrutinize the merits of compromise . . . in suits between individual litigants cannot affect the duty of a bankruptcy court to determine that a proposed compromise forming part of a reorganization plan is fair and equitable.

TMT Trailer Ferry, supra, 390 U.S. at 424. It follows that when a senior creditor's claim is settled, the compromise must satisfy the rule of absolute priority as well. The reviewing court must determine that the value of the proposed compromise distribution is fairly equivalent to the value of the potential claim surrendered. For the reorganization court that determination demands the exercise of "informed, independent judgment." *Id.* The program for the exercise of that judgment is established in the *TMT Trailer Ferry* opinion:

> There can be no informed and independent judgment as to whether a proposed compromise is fair and equitable until the bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in every instance, of course, is the need to compare the terms of the compromise with the likely rewards of litigation.

Id. at 424-25. This statement of the standard of review demonstrates that the weighing of claim against compensation cannot be an exact one. Nor should it be, since an exact judicial determination of the values in issue would defeat the purpose of compromising the claim. *Florida Trailer & Equipment Co. v. Deal,* 284 F.2d 567, 571 (5th Cir. 1960), *In re Equity Funding Corp.,* 416 F. Supp. 132, 146 (C.D. Cal. 1975). We conclude that the reorganization court properly held that the test was whether the terms of the proposed compromise fall "within the reasonable range of litigation possibilities." *In re Equity Funding Corp., supra,* 416 F. Supp. at 145.

The reorganization court carefully considered the competing contentions of the three Irving Trust bond issues and the Trustees before approving the allocations that are at issue on appeal. Its exercise of "informed, independent judgment" is entitled to "especial weight" upon review. *New Haven Inclusion Cases,* 399 U.S. 392, 463 (1970); *RFC v. Denver & R.G.W.R.R.,* 328 U.S. 495, 533 (1946). In a similar situation, the *TMT Trailer Ferry* Court suggested in dictum that had the record in that case clearly indicated that the reorganization court had given "adequate and intelligent consideration" to the factors outlined above, its approval of a proposed compromise would have been affirmed, despite the presence in the record of virtually uncontested facts indicating "the probable existence of valid and valuable causes of action." 390 U.S. at 434, 438-439. These intimations, when coupled with the customary injunction that judicial findings of fact should not be overturned on appeal unless they are clearly erroneous, suggest that on all factual issues our review should be highly deferential. We think, however, that the issue of whether, viewing the facts in the light most favorable to the Plan, a particular legal theory is reasonably likely to succeed, is one on which our review must necessarily be plenary.

We turn then to the evaluation of the compromise enforced upon these senior creditors by the proposed Plan of Reorganization. We have already discussed the nature and value of the claims held by the three bond issues, and have described the package of securities distributed to them under the Plan. We now proceed, first, to review the evidence relating to the value of the distribution under the Plan. We conclude that on any theory of valuation, as a result of the compromise, the claims of the three issues have been substantially discounted in that distribution. We then consider whether the proposed discount of the Irving Trust claims falls within a range of "reasonably probable" outcomes in a litigated liquidation.

2. *Evaluating the Compromise Distribution*

For each $100.00 of claim, the "super-secured" creditors receive $10.00 in cash, $30.00 face value of Series A Bonds, $30.00 face value of Series A Preference Stock and $30.00 face value of Common Stock. The reorganization court made no finding regarding the value of this distribution and that value is disputed upon appeal. The most significant evidence of value of distribution presented before the reorganization court related to the value of the Series A Bonds. The Trustees' expert witness testified that, even assuming the prompt retirement of A Bonds between 1978 and 1981 in accord with the proposed schedule, the present value of those future payments, given present interest rates, should be determined by applying a 16% discount rate to the amount of payments. When applied, this rate produces a value of $75.62 for each $100.00 face amount of A Bonds, or $22.69 for every $30.00 of face amount.

Because the Series A Preference Stock was created only after the hearing and briefing on the Plan, there is no

evidence in the record specifically relating to the value of A Preference Stock. On the most optimistic of assumptions, that is, assuming that the earnings test is met and cash is available, the majority of the Series A Preference Stock will be redeemed at $20.00 a share, on April 30, 1982. The remainder will be redeemed on April 30, 1983. Under no circumstances will the stock be redeemed before those dates, and there is an unknown but substantial likelihood that it will be redeemed later or not at all. In the interim, the stock bears no interest. Irving Trust argues that the present value of this contingent non-interest bearing promise to pay in the future should be determined by applying an 8% discount rate to the face value of the obligation. Applying this rate, the value in January, 1978 of payment in 1982-83 is $14.18 per share, or $21.27 per $30.00 of claim.

These figures, when summed with the cash distribution, produce a present value of $53.96 per $100.00 of claim for the cash and debt security portions of the proposed distribution. The Trustees did not offer any evidence of value tending to contradict these figures, and on appeal they do not contest their accuracy. Rather, they contend that because the proffered evidence and analysis go to the issue of market value, they fall within the general prohibition against the use of market value as a measure of the worth of reorganization securities.

This argument has two prongs. First, the Trustees argue that evidence of market value should be ignored because the market can be expected irrationally to undervalue the securities of a once-distressed company emerging from a lengthy reorganization. *In re Missouri Pac. R.R.*, 39 F. Supp. 436, 446 (E.D. Mo. 1941); *see also* Blum, *The Law and Language of Corporate Reorganization*, 17 U. Chi. L. Rev. 565, 566-69 (1950). That argument has considerable force when the securities in issue represent equity in, or long term interest bearing obligations of, a reorganized debtor. In such cases, the market value of the security will depend upon the investing public's perception of the future prospects of the enterprise. That perception may well be unduly distorted by the recently concluded reorganization and the prospect of lean years for the enterprise in the immediate future. Use of a substitute "reorganization value" may under the circumstances be the only fair means of determining the value of the securities distributed. When, however, the security contract is in essence a short term, non-interest bearing promissory note, whose value is largely independent of the long term fortunes of the enterprise, arguments based on the irrationality of the market are less persuasive. It can scarcely be contended that the market in commercial paper functions irrationally when it discounts a non-interest bearing future promise to pay in order to obtain its present value. Nor can the market be assumed to be irrational in questioning the precise date of payment on these obligations. The Trustees' own expert witness has testified that those payments are in doubt. It is therefore difficult for us to see why the distressed company rationale requires or permits us to ignore this evidence of value. Plainly, the promise of a dollar payable in several years is not worth 100 cents today.

The Trustees also urge that the Supreme Court has disapproved, on grounds of practicality, the use of precise dollar values in the determination of equitable equivalence. They rely for this proposition chiefly upon *Institutional Investors, supra*, where the Court stated:

> A requirement that dollar values be placed on what each security holder surrenders and on what he receives would create an illusion of certainty where none exists and would place an impracticable burden on the whole reorganization process. . . .

> [The] determination [of equitable equivalence] cannot be made by the use of any mathematical formula. Whether in a given case senior creditors have been made whole or received "full compensatory treatment" rests in the informed judgment of the Commission and the District Court on consideration of all relevant facts.

318 U.S. at 565-66. We think that the Trustees claim for this passage a meaning far broader than is warranted either by its context or by a fair reading of the absolute priority rule. The quoted statement was made in the context of a dispute concerning the proper compensation to be awarded to two parallel mortgages on different operating divisions of the debtor railroad. One division had historically been profitable; the other had generally lost money. The Plan proposed to consolidate both mortgages into an integrated financial structure. As Justice Douglas described it, the goal was "to fit each into the hierarchy of the new capital structure in such a way that each will retain in relation to the other the same position it formerly had in respect of assets and earnings at different levels." *Id.* at 563. This problem of parallel valuation raised corporate finance issues of considerable sophistication. Moreover, the issues of valuation involved required that the Court review the Plan's proposed attribution of the corporation's future profit and loss to particular encumbered assets, as well as its estimate of the amounts of those profits and losses. The evidence bearing upon these issues of valuation was conflicting and complex. *See id.* at 559-61.

It was in the context of this difficult problem of valuation and distribution that Justice Douglas stated that the use of dollar values "would create an illusion of certainty" and unduly burden the reorganization process. The wisdom of that position, in context, is indisputable. But it is not apparent that this statement was intended for universal application. First, Justice Douglas was careful to stress that the contest between the two mortgages was not one between senior and junior creditors, where the rule of absolute priority would have applied, but rather one between two first liens on different assets. *Id.* at 562-63. Second, the valuation issues in dispute were extremely complex and subject to substantial conflicting evidence. Here, in contrast, the valuation problem presented is relatively simple, and the evidence bearing upon it is clear and uncontradicted.[7] Recognizing this evidence would pose no burden on the reorganization process. Finally, in the absence of *any* other evidence in the record bearing on the value of the debt issues we question whether meaningful review would be possible if this evidence of value were not recognized. Surely we cannot be expected to review the proposed allocations under the Plan on the patently false assumption that these non-interest bearing debt securities have a "reorganization value" equal to their face value despite their deferred maturities. Some discount must be recognized, and no basis for taking account of that discount other than that proposed by Irving Trust has been suggested either in the reorganization court or on appeal. Moreover, we think that Irving's proposed discount rates are reasonable. The 16% discount rate applied to the Series A Bonds was suggested by the Trustees' own expert witness. In light of this concession, the 8% discount rate which Irving suggests should be applied to the more speculative A Preference Stock is conservative, and for that rea-

7. Similarly in *RFC v. Denver & R.G.W.R.R.*, 328 U.S. 495, 517 (1946), also relied upon by the Trustees as authority for their position, the records apparently contained sharply conflicting evidence of value. Were such evidence in the record here, we would, of course, have deferred to the conclusions of the finder of fact, as did the Court in *RFC, supra.*

son we do not think that the fact it was not formally presented before the district court prevents us taking notice of it here.

The Irving's proposed values for the debt securities must, therefore, in the absence of other conflicting evidence, be given substantial weight on this appeal. We do not, however, regard the precise dollar figures proposed as controlling. We are under no illusion that the apparently mechanical application of a particular discount factor produces results so precise that they ought, in close cases, to swing the decision of a reviewing court. But on any reasoned review of the evidence, Irving Trust has established that the cash and fixed dollar securities, bonds and preference stock, distributed under the Plan have a value no greater than 55-60% of the face value of the claim surrendered.

We cannot, however, agree with Irving Trust's further contention that a precise dollar value can be placed on the Common Stock of the reorganized debtor for purpose of valuing the entire securities package. Such a valuation, which necessarily depends heavily upon the long term performance of the reorganized debtor and the uncertain outcome of the Valuation Case, falls within the prohibition against reliance upon market value which usually applies to reorganization securities. We do think, however, that the Irving Trust's proposed $6.00 per share valuation, which assumes no recovery from the Valuation Case and weak earnings performance by the debtor, can usefully be viewed as establishing a floor for the value of the Common Stock. If this is the case, then the minimum value of the proposed distribution to super secured creditors is in the range of $60.00 to $65.00 per $100.00 of claim. Further recovery, up to and perhaps in excess of 100 cents on the dollar, will be wholly contingent upon outstanding performance by the reorganized debtor and a large recovery in the Valuation Case.

3. *The Impact of Administration Claims*

The foregoing analysis of the value of the proposed distributions frames the issue. The appellant creditors are required to surrender the right to defend security amounting to 113%, 123% and 274%, respectively, of their claims in a litigated liquidation, plus the right to recover for any shortfall as a secured creditor in the Valuation Case. In return, they receive a distribution which has an assured value no greater than 65% of their claim, and a speculative right to benefit from a large recovery in the Valuation Case and high future earnings up to, and perhaps in excess of, that claim. For purposes of review, we will assume that the right to recover in the Valuation Case as a secured creditor is in some broad sense equivalent to the possibility of recovering an amount greater than that claim as a common stockholder of the Reorganized Company. Leaving these elements of the claim aside, the core question, thus, is whether the proposed guaranteed recovery of 65 cents for each doller of claim represents a fair compromise of the potential claims against the retained security of the three bond issues.

In a litigated liquidation, the security backing the Irving Trust issues could be subject to potential invasion from four sources: Claims of the federal government, pre- and post-petition claims of state and local tax claimants, and other costs of administration. We think that on a "worst case" analysis all of these claims except those for pre-petition taxes might reasonably be found to prime the security of the three Irving Trust bond issues.

The obligations to the United States creditors comprise: $56,200,000 principal and interest due on Trustees' Certificates held by the United States and in default since 1976; $51,800,000 of Trustees' Certificates guaranteed by the United States and due in 1986, and $368,100,000 due

to the United States Railway Association (USRA) for loans made pursuant to section 211(h) of the RRRA. These debts are costs of administration entitled to first priority. "Had the United States not provided the funds to pay, the trustees would be dealing with an equal amount of unpaid obligations held by a multitude of individual creditors and suppliers. . . . [t]he United States is both equitably and legally fully entitled to rights incident to an unpaid administrative debt." Staff Report of the SEC on Plans of Reorganization 81, Joint App., Vol. I, Book 3 at A-1200. In a litigated liquidation the United States could reasonably contend that its claims were entitled to priority ahead of other costs of administration and of secured creditors. With respect to claims of state and local taxing authorities, which make up the bulk of other costs of administration, the priority of federal claims is made clear in the statute, 45 U.S.C. § 721(h)(1), (3)(B) (1976 Supp.), and its legislative history, *see* H.R. Rep. No. 1743, 94th Cong., 2d Sess. 34-35, *reprinted in* [1976] U.S. Code Cong. & Ad. News 5846, 5857-58. With respect to secured creditors the case for federal priority emerges implicitly from the provisions of the RRRA. In terms, § 211(h) does not specify how much of the debtor's property is to be primed by loans made pursuant to the statute. Other portions of § 211, however, suggest an arguable contention that the government intended to take a lien on *all* of the debtor's property. Section 211(e), for example, which delineates the prerequisites for § 211(h) claims, provides that before any loans are extended, the United States Railway Association must make a finding in writing that, *inter alia*, "the applicant has offered such security as the Association deems necessary to protect reasonably the interests of the United States." Section 211(f) provides, in addition, that:

> (f) Policy.—It is the intent of Congress that loans made under the section shall be made on terms and conditions which furnish reasonable assurance that the Corporation or the railroads to which such loans are granted will be able to repay them within the time fixed and that the goals of this chapter are reasonably likely to be achieved.

45 U.S.C. § 721(f). Plainly, the government wished substantial assurances that its loans would be repaid.

The Irving Trust bondholders contend, however, that the possible federal priority could not reasonably have been intended to reach non-operating assets like their collateral. A reasonable argument can be made, however, that even non-operating assets were primed by the federal claims. The debtor's *operating* assets were surely an unlikely source for such repayment since they had produced no profits for years. It seems likely that the government was looking to the non-operating assets for its security. This view of congressional intention is reinforced by the reality that non-operating assets like the Park Avenue Properties were long recognized as vital contributors to the continued operations of the railroad. Thus, in adjudicating the demands of Penn Central creditors that certain properties of the debtor not be sold, this court quoted with approval from the *Penn Central Merger Cases,* 389 U.S. 486, 510-11 (1968):

> While the rights of the bondholders are entitled to respect, they do not command procrustean measures. They certainly do not dictate that rail operations vital to the Nation be jettisoned despite the availability of a feasible alternative. The public interest is not merely a pawn to be sacrificed for the strategic purposes or protection of a class of security holders whose

interests may or may not be served by the destructive move.

In re Penn Central Transportation Co., 484 F.2d 323, 330 n.37 (3d Cir.), *cert. denied*, 414 U.S. 1079 (1973). With this holding in mind, it seems reasonable to conclude that the debtor's non-operating assets were intended to be subject to the government's lien for RRRA administration expenses. If so, then the Irving Trust bonds were primed by $476.1 million of federal claims.

Irving Trust points out that even if the federal claims were held to prime its security, those claims could be fully satisfied from $586,125,000 in unencumbered assets of the debtor. Indeed, the bondholders argue, the unencumbered assets of the estate would, in addition, be sufficient to pay off almost all of the $118,000,000 of other administrative costs (exclusive of state and local taxes) of the reorganization as well, leaving their security essentially unimpaired.

The bondholders contend, however, that their potential liability on a worst case basis is limited to the federal government claims. Conceding, as they must, that both the $118,000,000 of other administrative costs and the $449,800,000 of state and local tax claims are costs of administration entitled to first priority in this proceeding, the Irving Trust bondholders argue that under settled principles of bankruptcy law, these costs may not be assessed against their security absent a showing that the security was benefited by the claim. *In re Lehigh Valley Railroad Co.*, 558 F.2d 137 (3d Cir. 1977); *Central Railroad Co. of New Jersey v. Manufacturers Hanover Trust Co.*, 421 F.2d 604 (3d Cir.), *cert. denied*, 398 U.S. 949 (1970); 5 *Collier on Bankruptcy* ¶ 77.21 at 611 n.21 (14th ed. 1978). This rule is, as Collier points out, simply an adaptation to the reorganization context of the general principle applicable

under section 64 of the Bankruptcy Act, 11 U.S.C. § 104 (1976). *See* 6A *Collier on Bankruptcy* ¶ 13.14[2] at 635 (14th ed. 1977).

As it applies to the security of the Collateral Trust Bonds, this argument has two weaknesses. First, the R & I Bonds, which make up a principal element of their security, are in turn secured by the most junior lien upon real property of the debtor which would probable be held liable for both taxes and costs of administration. And as to the P&LE Bonds, we think that the bondholders too cavalierly assume that in a litigated liquidation no finding of benefit to their security could be made. The value of the P&LE stock is, after all, dependent upon the financial health of the P&LE itself. That railroad interconnects closely with the Penn Central system, and a large portion of its earnings no doubt arise from traffic which passes over that system. In addition, the P&LE realizes substantial income from leasing its excess equipment to other railroads in the Northeast. Both of these aspects of the P&LE's profitable business, we think, might reasonably have been found to depend, in substantial part, upon the continued operation of the Northeast rail system that this reorganization made possible. A finding that the Collateral Trust bonds benefited from the reorganization seems far from improbable.

The Mohawk & Malone bonds, which are secured by assets of a railroad which ceased to operate in 1972, have a stronger claim to resist the incursion of administration claims, since it is difficult to see how that security benefited at all from the continued operation of the system after that date. But both the Collateral Trust security and the Mohawk & Malone security were arguably rendered subject to administration claims as a result of the condemnation of the Debtor's assets by the RRRA. That statute

compelled the debtor to continue operations despite overwhelming evidence that the Debtor was not reorganizable on an income basis, and relegated secured creditors to the Valuation Case for any losses that resulted from those operations. A reasonable argument can be made that the effect of this compelled continuation of operations was to elevate the expenses essential to those operations—such as property taxes and other costs of administration—to a position where they would prime secured creditors and relegate those creditors to the Valuation Case. In its worst case analysis, the reorganization court also assumed that $73,400,000 of pre-petition states and local taxes might prime secured creditor security in retained assets. We do not agree that this result was reasonably probable. No court would be likely to hold that unpaid pre-petition taxes "benefited" secured creditors. Moreover, it is difficult to conceive of such taxes being treated as expenses of administration in a § 77 or any other bankruptcy proceeding. However, such taxes are given a fourth priority in § 64, and although that section is not generally applicable under § 77, it has been held to apply to tax claims in those proceedings, at least so far as to permit priority over general unsecured creditors.[8] It has never been suggested, however, that a § 64 tax priority primed a lien, probably because of the proviso in § 64

> [t]hat no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the interest of the bankrupt estate therein. . . .

The bankrupt estate has no equity in any retained assets covered by the Irving Trust and Bank of New York indentures. Since neither statutory nor caselaw authority suggests an argument whereby the $73,400,00 in pre-petition taxes would prime secured creditors, there is no reasonable likelihood of that result in litigation. If there is any claim in the taxing authorities it can amount to nothing stronger than that with respect to specific assets some taxing authorities have statutory liens valid under state law against mortgagees. On the record before us, however, there is no indication that any of the retained assets to which Irving Trust and Bank of New York primarily look are subject to such liens in significant amounts. Thus for the purpose of evaluating litigated liquidation possibilities we conclude that even a worst case result would place the bulk of the $73,400,000 in pre-petition tax claims behind the liens of their indentures.

8. *E.g., In re Denver & R.G.W.R.R.*, 23 F. Supp. 298 (D. Colo. 1938); *In re New York, O. & W. Ry.*, 25 F. Supp. 709 (S.D. N.Y. 1937); *In re Missouri Pac. R.R.*, Bankr. L. Rep. (CCH) ¶ 3780 (E.D. Mo. 1935), *aff'd sub nom. J. P. Morgan & Co. v. Missouri Pac. R.R.*, 85 F.2d 351 (8th Cir.), *cert. denied*, 299 U.S. 604 (1936).

Summarizing, the claims which the district court could reasonably have concluded would prime the Irving Trust bondholders in a litigated liquidation are as follows:

Federal claims	$476,100,000
State & Local Taxes	$449,800,000
Other Costs of Administration	$118,000,000
Total	$1,043,900,000

In a worst case liquidation, the appellants argue, this $1,043,900,000 would be assessed against the consolidated assets of the debtor and the leased lines, which total $1,848,969,000, of which $586,125,000 is unencumbered, and $1,262,844,000 encumbered. In such a liquidation, the unencumbered assets would be reduced to roughly $805,069,000 or 64% of their original total value.

This is not, however, the true worst case analysis. In their submissions to the reorganization court, the Trustees

outlined a scenario in which all of the above priority claims, plus the pre-petition taxes, were assessed against the retained assets of the primary Debtor, PCTC, alone, excluding the assets of the Secondary Debtors. In that eventuality, the court concluded that all of the Debtor's unencumbered assets would have been consumed, and $615,000,000 of the $925,971,000 of the debtor's retained encumbered assets would have been consumed as well. While such an analysis surely involves numerous draconian assumptions, it presents a truer worst case analysis than that proposed by the bondholders. Adopting a similar approach, we calculate that to assess the $1,043,900,000 of potentially priming claims against the $1,425,494,000 of retained assets of the Debtor alone would swallow all unencumbered assets and would reduce retained secured assets from $925,971,000 to $381,594,000—41% of all encumbered retained assets—at the close of a liquidation. With these possible worst case outcomes in mind, we turn to the specific situation of the three bond issues.

In a worst case litigated liquidation like the one described above, the New York Central 6's would be severely at risk. Their claim is 113.28% secured. But 17% of that security is in R & I Bonds, whose value, because of their junior lien position, would almost certainly be wiped out in such a liquidation. The claim is thus effectively secured roughly 100% by the P&LE stock. The foregoing analysis makes clear that that security would be subjected in the "worst case" to massive priming claims which might reduce it to as little as 41% of its value. Under the circumstances, we cannot say that a proposed distribution constituting roughly 60% of their claim does not represent a fair and equitable compromise of the litigation possibilities.

A similar conclusion applies to the Penn Central 6's. They are slightly better secured than the New York Central

bonds (123% to 113%), but not in an amount so much greater as to avoid the impact of the foregoing analysis. We think that the proposed distribution is a fair compromise of their claim to survive the liquidation.

4. *The Mohawk & Malone Bonds*

The Mohawk & Malone Bonds, however, present a wholly different case. They are 273.77% secured by retained assets. Even assuming that fully 60% of their security was found to be primed by the priority claims outlined above, more than 100% of their claim would remain secured, and they would be entitled to receive the full amount of that claim at the close of the liquidation. On any more moderate assumption their claim would remain much more than 100% secured. We think therefore that the Plan's proposed distribution is not, as to them, a fair and equitable compromise within the reasonable range of litigation possibilities.

The reorganization court, without addressing the particular strength of the Mohawk & Malone claim, referred to timing as a factor. Undoubtedly it is. But a secured creditor is entitled to be paid in full with interest to the date of payment. On any realistic appraisal of the length of time a litigated liquidation might take, even on a worst case basis it is very likely that this group of bondholders would receive both principal and interest in full. It seems to us inconsistent with the *TMT Trailer Ferry* ruling to tender to them a package of securities in which some forty percent of their claim is converted to common stock of concededly contingent value.

We conclude that the Plan must be modified to improve the distribution to the Mohawk & Malone Bondholders. In this regard, Irving Trust suggests that the fairest solution is to allow the Mohawk & Malone claim to be satisfied in full out of the escrowed cash that is its security.

While a strong argument might be made for such treatment, we think it is undesirable to establish a precedent that secured creditors may demand cash satisfaction for the secured portion of their claim upon consummation of the plan. If such a principle were recognized, we see no reasoned distinction between the right of a creditor who can show that he is 100% secured by retained assets in a worst case liquidation to a 100% cash settlement of his entire claim and that of a creditor who can show that he would be at least 30% secured by retained assets to a 30% cash settlement. As the Trustees suggest, such a requirement of cash satisfaction would be inconsistent in principle with feasibility requirements. *See Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 117 (1939).

The preferable solution is to award the Mohawk & Malone Bondholders Series A Bonds for the 90% of face amount of their claim that is to be satisfied in reorganization securities. Of all the securities issued under the Plan, A Bonds have the best likelihood of prompt and certain payment. On the other hand, it is also true that the Series A Bonds, which have deferred maturities and carry no interest until 1981, cannot fairly be valued at their face amount. Mathematical precision, however, is not to be expected of any plan of reorganization. We think that given the limited range of securities in the present plan, our proposed award of Series A Bonds represents the best means short of a direct cash payment of assuring that these bondholders receive an award that is the equitable equivalent of their surrendered claim.

II. THE R & I APPEAL [9]

The $214,470,000 claim of the R & I Mortgage was treated under the Plan as fully secured, but not super-

9. Our disposition of the contentions offered by the Bank of New York as indenture trustee for the R & I bondholders applies

secured. Thus, unlike the Mohawk & Malone and Collateral Trust bondholders, the R & I bondholders are allocated Series B Preference Stock for 30% of their claim. The Bank of New York, as indenture trustee for the R & I mortgagees, does not contest this allocation. It does object, however, to the allocation to its claim of Series A and B bonds. As we noted above, Series A Bonds are allocated under the Plan to the extent that a claim is secured by retained assets.[10] The R & I indenture trustee urges that in calculating its share of A Bonds the reorganization court significantly underestimated the value of its security in retained assets. That security, in relevant part, is said to be found in three sources. The first is a junior mortgage lien on what, throughout these proceedings, has been described as the Park Avenue properties, and on the rental stream generated by them.[11] The second is a pledge of 163,426 shares of the capital stock and 26,591 shares of the preferred stock in the New York and Harlem Railroad

9. (Cont'd.)

equally to those offered by Harriet Signer, et al., bondholders under the R & I Mortgage, who have separately appealed but present identical objections to the Plan.

10. Under the Plan the R & I bondholders are considered 31.9% secured by retained assets. The distribution to them is as follows:

Cash	$ 21,447,000
A Bonds	20,524,000
B Bonds	43,817,000
B Preference Stock	64,341,000
New Common Stock	64,341,000
Total	$214,470,000

11. These New York City properties include the Waldorf Astoria, Biltmore, Barclay, Roosevelt and Commodore Hotels, and the Bankers Trust, American Brands, Pan Am, Westvaco, Union Carbide, Chemical Bank, ITT, Graybar, and Manufacturers Hanover office buildings. The properties and liens thereon are described in detail in *In re Penn Central Transportation Company*, 354 F. Supp. 717 (E.D. Pa. 1972), *aff'd in part, modified and rev'd in part*, 484 F.2d 323 (3d Cir.), *cert. denied*, 414 U.S. 1079 (1973).

Company, which owns the fee upon which the debtor has a long-term lease ("the Harlem lease"), a condition of which is the payment of dividends on the stock. The third is a lien on all indebtedness, liens or charges acquired by the debtor against any company, a majority of whose shares are subject to the R & I Mortgage.

A. The Park Avenue Rentals and Harlem Stock Dividends

During the course of the reorganization, the Trustees collected from Park Avenue tenants approximately $76 million of rentals, net of property taxes but before certain maintenance expenses, depreciation and amortization of leasehold improvements.[12] Although these rentals secured the R & I Mortgage (and others), they were entirely expended during the reorganization. Twice during that process the R & I indenture trustee requested that the rents be sequestered, and twice that request was denied. The Bank of New York now contends that the R & I mortgagees should have been granted retained asset credit for the Park Avenue rentals expended by the Trustees in support of deficit rail operations.

The indenture trustee also claims retained asset credit for dividends due but not received on the Harlem Stock pledged under the R & I mortgage. The Harlem lease obliges the debtor to pay to Harlem, as part of its rent, $5 per annum for each share of Harlem stock, representing the amount of Harlem's annual dividend. The debtor is not required to make such dividend rental payments on shares pledged to the R & I indenture trustee, however, except upon default under the terms of the pledge. Since the debtor did default, the indenture trustee was, during the course of the reorganization, entitled to Harlem dividend payments. But in 1972, in granting the petition of the Trustees to affirm the Harlem lease, the reorganization court ruled that until its further order the Trustees should not pay the rentals needed to pay dividends on the stock pledged to the R & I mortgagees. Thus, while under the indenture the R & I trustee was entitled to receive the dividends, approximately $7.1 million was withheld. This occurred despite the fact that dividends on Harlem stock held by the public were paid throughout the reorganization.

Objections to the diversion of rentals and dividends, identical to those offered by the Bank of New York as successor trustee under the R & I mortgage, have heretofore been presented to this Court. In *In re Penn Central Transportation Company (Park Avenue Properties)*, 484 F.2d 323 (3d Cir.), *cert. denied*, 414 U.S. 1079 (1973), Judge Adams wrote:

> [The indenture trustee] asserts that because these shares have passed from the Penn Central to the mortgage trustee as a result of the default, it is entitled either to receive the dividends accrued and those that come due or to have these claims ranked as an administrative claim.
>
> The district court, relying on this Court's opinion in In re Philadelphia & Reading Coal & Iron Co., [117 F.2d 976 (3d Cir. 1940)] held that the income produced by the pledged shares was available to the Trustees of the Penn Central and need not be paid to the pledgee. Having thus denied the claim for immediate payment, the district court deferred a determination of the status to be accorded [the R & I] claim until the formulation of the reorganization plan. We affirm these holdings of the district court.

12. This figure represents rentals collected between June 30, 1970 and December 31, 1976. *See* Joint App., Vol. II at A-349. The Trustees do not dispute its accuracy. *Trustees' Brief* at 75.

484 F.2d at 335-36. That decision plainly forecloses any contention that rentals and dividends may not be invaded for reorganization purposes. The case does not, however, decide how a secured creditor whose income stream has been involuntarily diverted for operating expenses should be compensated for that diversion. It clearly leaves open for future determination the contention that, just as holders of trustees certificates are treated as administration expense claimants, so too these involuntary lenders should be given similar treatment under the Plan.

The indenture trustee's claim for compensation for the loss of income stream security is particularly striking in contrast to the treatment of creditors whose security was in the proceeds of the sale of mortgaged properties. Such proceeds were required to be escrowed and are now available as retained assets. *See In re Penn Central Transportation Company (Selkirk Yard),* 474 F.2d 832 (3d Cir. 1973). The Bank of New York points to this apparent inequity as a basis for granting it additional retained asset credit.

The Trustees respond to this contention by asserting an ostensible distinction between *income* from mortgaged property, and *proceeds* from the *sale* of mortgaged property. The former, they assert, has always been available for the debtor's use during reorganization, while the latter's use is, "in general, not permissible." *Trustees' Brief,* at 78. In support of this proposition, the Trustees cite *Selkirk Yard, supra. Id.* But that case supports no such distinction. In *Selkirk Yard* Judge Adams permitted the Trustees of Penn Central to use monies from the sales of mortgaged properties in connection with the improvement of a major switching yard. Significantly, however, he not only endorsed the reorganization court's order that

the Trustees replace the principal borrowed from the proceeds of those sales; he also insisted that the Trustees pay interest on the funds, at the market rate, for the period of time that the funds would not themselves be drawing interest. 474 F.2d at 837. Thus, the court recognized that there is no essential difference between security in the escrow fund and security in the income stream which the fund produces.

More recently, in *In re Lehigh Valley Railroad Co.,* 558 F.2d 137 (3d Cir. 1977), we had occasion to reiterate our view that there is no material distinction, for reorganization purposes, between income and proceeds from sales. In *Lehigh Valley,* the court considered the claims of certain bondholders for the sequestration of rents from mortgaged property, and held that the four-pronged test of *Central Railroad of New Jersey v. Manufacturers Hanover Trust Company,* 421 F.2d 604 (3d Cir.), *cert. denied,* 398 U.S. 949 (1970), was applicable. In so ruling, Judge Forman wrote:

> We can find no legal justification for the disparate treatment in these proceedings of proceeds from the sale of mortgaged property, and the interest thereon, and income from the rental of mortgaged property. Nor do we discern any reason for the application of different standards in the two instances. There is nothing in § 77 from which one may infer an intent to distinguish between property and income derived therefrom. *See In re Philadelphia & Reading Coal & Iron Co.,* 117 F.2d 976 (3d Cir. 1941).

421 F.2d at 148-49.

Selkirk Yard and *Lehigh Valley,* taken together, establish that there should be no difference in treatment between those creditors holding security in property and those

holding security in an income stream produced by the property.[13] In *Lehigh Valley,* moreover, we relied upon *In re Philadelphia & Reading Coal & Iron Co., supra.* The latter case holds that "the right of the mortgage trustee ultimately to receive the income of the mortgaged and pledged property . . . [becomes] fixed on . . . the day the petition for reorganization [is] approved by the court. . . ." 117 F.2d at 978. In the instant case, the security which the R & I bondholders had in the two income streams in question on the date of approval of the petition for reorganization was diverted to pay operating expenses, and thus to reduce administration expenses arguably priming the retained asset security of other creditors. With respect to those other creditors, then, fair and equitable treatment would seem to require some recognition that, starting out equal, the R & I bondholders have been made less secure and the others more so. It is a settled principle of reorganization law that a mortgagee whose security has been dissipated for reorganization purposes is entitled to equitable treatment in a plan of reorganization in compensation for that loss. *E.g., In re Yale Express Sys., Inc.,* 384 F.2d 990, 992 (2d Cir. 1967); *In re New York, New Haven & Hartford R.,* 147 F.2d 40, 48 (2d Cir. 1945).

If this were an ordinary reorganization, we think it would be necessary to treat the security diverted to operating expenses no worse than other costs of administration

13. There is, to be sure, some support in past decisions of this court for the Trustee's claim that income from property is more vulnerable to depletion for reorganization purposes than are proceeds from the sale of mortgaged property. *See* Webster, *Collateral Control Decisions in Chapter Cases: Clear Rules v. Judicial Discretion,* 51 Am. Bankr. L.J. 197, 216-21 (1977) (citing cases). But this position has been roundly criticized by commentators, *see, e.g., id.* at 216; Countryman, *Real Estate Liens in Business Rehabilitation Cases,* 50 Am. Bankr. L.J. 303, 334 (1976), and rejected by subsequent Third Circuit decisions. *See, e.g., Selkirk Yard, supra; Lehigh Valley, supra. See also In re Pittsburgh-Duquesne Development Co.,* 482 F.2d 243 (3d Cir. 1973).

incurred for such purposes, or at least to equalize in some manner the treatment of secured creditors whose assets were dissipated and those whose assets were retained. This, however, is not an ordinary reorganization. Here, after the reorganization court determined to use the R & I security for reorganization purposes, Congress passed the RRRA, which in effect condemned a large part of the debtor's estate. That action effectively relegated some creditors to the security of a Tucker Act remedy. Many of the claims being asserted in that proceeding are for the expenditure of security in the deficit operation of the railroad. Thus, a number of creditors have suffered the same sort of invasion of their security as did the R & I bondholders. The former might argue that they should be treated no less favorably than the latter. There is, however, a difference. The decision to divert the income stream securing the R & I bonds was made by the reorganization court, and approved by this court in the *Park Avenue Properties* appeal, at a time when the Trustees still contemplated a capitalized earnings plan of reorganization. The diversion was also well before the RRRA mandated the apparent inequity. To be sure, with the passage of the RRRA, the reorganization court could not do other than to relegate the targets of the condemnation to the proceeds of the Valuation Case. But it need not compound inequities by abandoning the original understanding upon which it authorized the Trustees to use the rental and rental dividend income. The eventuality of the RRRA should not shield from scrutiny the fact that creditors holding security in escrowed proceeds of sale, for example, are being given unexpectedly better treatment, not only than the creditors whose assets the government condemned, but also than those whose assets the trustee borrowed. To the extent that the estate has retained assets,

the fair and equitable standard of § 77(e) governs. One aspect of that standard is that a creditor whose claim is the equivalent of an administration expense claim is entitled to be paid ahead of secured creditors who benefited from the expenditure. Clearly, the invasion of the R & I income stream security did benefit the holders of retained asset security by shielding them, to the extent of the expenditure, from erosions. Moreover, § 77(e) requires that holders of like security be treated equally. While that may not be possible when the government condemns property, it is required when the Trustees and the reorganization court selectively choose security for impairment in the course of a reorganization.

We conclude, therefore, that the reorganization court's rejection of the R & I bondholders' claim for recognition of their security in the Park Avenue rentals and Harlem rental dividends cannot be approved. But on the present record it is not possible to determine precisely the extent to which such recognition is required. To the extent that the rentals collected from the Park Avenue properties were reinvested in improvements in those properties which increased their value, there has not been an impairment of the R & I bondholders' security. The reorganization court, having rejected the indenture trustee's claim, had no occasion to calculate the value of such reinvestment, if any.[14] Moreover, while the Trustees concede that they collected $76 million in rentals, it is clear that even if these rentals had been sequestered, they would necessarily have been reduced by the costs associated with their collection. These costs include maintenance, depreciation, and administrative services, burdens which were borne entirely

14. On remand we would direct the court's attention to a June 22, 1977 memorandum, purporting to value the improvements made in the Park Avenue properties at $16,371,000. Joint App., Vol. II at A-350.

by the Trustees. They should be deducted in determining the actual invasion of the R & I security. When such a net calculation is made, a fair and equitable treatment of the R & I bondholders would be to allocate to them Series A Bonds in proportion to the degree that their retained asset security is thereby increased.

B. The Lien on Indebtedness of Leased Lines

The R & I indenture trustee's third claim for an increased allocation of Series A Bonds is predicated upon a provision in the indenture giving the R & I bondholders a lien on the indebtedness to Penn Central of any company a majority of whose stock is pledged to the trustee under the R & I mortgage. This clause, it is said, gives the indenture trustee title to an administration expense claim against leased lines which were, during the reorganization, operated by the Trustees at a substantial loss for the account of the lessors. If the indenture has this effect, the argument continues, then that administration expense claim primes the interests of those secured creditors whose security is in the retained assets of the debtors owning those lines.

The reorganization court rejected this argument for at least two reasons.[15] First, it observed that even if there were an administrative expense claim for losses in the operation of leased lines, it would not be the property of Penn Central, but rather the property of the Trustees. The court reasoned that any operating losses which might give rise to chargeback claims were made possible by the reorganization process, and by funds made available from

15. The reorganization court advanced as a third basis for rejecting this contention the fact that the debtor may not have actually rejected the leases in question, and thus no chargeback right against the leased lines ever arose. Because of our disposition of the court's other reasons for denying the R & I claim for chargebacks, we express no view on this issue.

the Penn Central estate as a whole. As the reorganization court stated, "[t]o say that this detriment suffered by the estate as a unit should now be redressed, but only for the benefit of the R & I Mortgage, is to express a strange view of the equitable powers of a federal court." *In re Penn Central Transportation Co.*, 458 F. Supp. 1234, 1305 (E.D. Pa. 1978).[16] It concluded, moreover, that the draftsmen of the R & I indenture had not intention of producing the anomalous result of subordinating the security of third-party creditors of the leased lines to the claim of the R & I bondholders. We find these reasons persuasive and agree with the reorganization court that the claim for charge-backs was properly rejected.

16. The court's conclusion that chargeback rights belong to the trustee of the estate, in view of his role as a manager of the debtor's reorganization, seems amply supported by related case and statutory law. A trustee is appointed to supervise the reorganization of a railroad pursuant to 11 U.S.C. § 205. He is given legal title to the railroad's property for the special purpose of rehabilitating the company. *See, e.g., Thompson v. State of Louisiana*, 98 F.2d 108, 110 (8th Cir. 1938). That title is exclusive and thus, for example, a debtor railroad corporation is not liable for personal injuries caused by negligent operation of the railroad by the trustees. *Detwiler v. Chicago, R. & P. Ry. Co.*, 15 F. Supp. 541 (D. Minn. 1936). Among the powers which are vested in the trustee, consistent with his function of reorganizing the company, is the power to reject leases. *See generally In re Penn Central Transp. Co.*, 382 F. Supp. 821 (E.D. Pa. 1974), *aff'd*, 510 F.2d 969, 970 (3d Cir. 1975); *In re Hoboken Mfrs. R. Co.*, 56 F. Supp. 187 (D. N.J. 1944), *aff'd*, 150 F.2d 921 (3d Cir. 1945), *rev'd sub nom. on other grounds, Smith v. Hoboken R.R., Warehouse and Steamship Connecting Co.*, 328 U.S. 123 (1946). Once such a lease is rejected, the operation of the leased line is for the account of the lessor. 11 U.S.C. § 205 (c)(6) (1946); *In re Penn Central Transp. Co.*, 382 F. Supp. 821, *aff'd*, 510 F.2d 969, 970 (3d Cir. 1975). It seems plausible to assume that the power to reject a lease, which is vested in the trustee so as to further the reorganization of the debtor, includes within it the power to supervise the operation of the leased lines and effect any chargeback which arises. Since this entire procedure is mandated by exigencies of reorganization, it is unlikely that Section 77 contemplated the preemption of the chargeback funds by prior lienholders.

CONCLUSION

The order confirming the plan of reorganization must be affirmed in all respects except two. The appeal of Irving Trust Company as indenture trustee under the Mohawk & Malone Railway Company first mortgage dated July 1, 1892 requires that the case be remanded to the reorganization court for modification of the Plan of Reorganization in a manner consistent with Part I of this opinion. The appeal of the Bank of New York as successor indenture trustee under the New York and Hudson River Railroad Company Refunding and Improvement Mortgage of October 1, 1913 requires that the case be remanded for further proceedings with respect to its claim for recognition of its interest in the Park Avenue rentals and Harlem dividend rentals consistent with Part II of this Opinion.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1692/78-1694, 78-1698
78-1716, 78-2314
and 78-2316/78-2318

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

THE BANK OF NEW YORK, as successor trustee under the New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage dated October 1, 1913,

Appellant in Nos. 78-1692, 78-1693, 78-1694, 78-2316/78-2318

THE IRVING TRUST COMPANY, as Indenture Trustee,

Appellant in Nos. 78-1698 and 78-2314

HARRIET SIGNER, SEYMOUR GILLMAN, ANNE FRANK and McMASTER HOLDING CO., bondholders under the New York Central and Hudson River Railroad Co. Refunding & Improvement Mortgage, dated October 1, 1913 (the "R & I Mortgage"),

Appellant in No. 78-1716

(D.C. No. B-70-347 In Bankruptcy)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Present: ALDISERT, GIBBONS and HIGGINBOTHAM, *Circuit Judges*

JUDGMENT.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the orders of the said District Court approving and confirming the Plan of Reorganization at District Court numbers 131, 195, 3455, 3707, 149 and 215 be, and the same are hereby affirmed in all respects except two. The appeal of Irving Trust Company as indenture trustee under the Mohawk & Malone Railway Company first mortgage dated July 1, 1892, requires that the case be remanded to the reorganization court for modification of the Plan of Reorganization in a manner consistent with Part I of this opinion. The appeal of the Bank of New York as successor indenture trustee under the New York and Hudson River Railroad Company Refunding and Improvement Mortgage of October 1, 1913 requires that the case be remanded for further proceedings with respect to its claim for recognition of its interest in the Park Avenue rentals and Harlem dividend rentals consistent with Part II of this Opinion. In light of the above, the cause be, and the same is hereby remanded for further proceedings in accordance with the opinion of this Court.

ATTEST:

THOMAS F. QUINN
Clerk

January 11, 1979

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1697 and 78-2313

In the Matter of:
PENN CENTRAL TRANSPORTATION COMPANY, DEBTOR;

BANKERS TRUST COMPANY,
Appellant in Nos. 78-1697 and 78-2313

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

(D.C. No. B-70-347 In Bankruptcy)

Argued October 16 and 17, 1978

Before GIBBONS and HIGGINBOTHAM, *Circuit Judges**

(Opinion filed January 11, 1979)

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Attorneys for Richard Joyce Smith, Trustee of the Property of the New York, New Haven and Hartford Railroad Company, Debtor

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OPINION OF THE COURT

Per Curiam

We deal herein with appeals filed by Bankers Trust Company, indenture trustee under the Consolidation Mort-

gage of June 20, 1913. For the reasons set forth in the opinions in Nos. 78-1698/1700, 78-1702/03, 78-1710, 78-2311/12, 78-2314/15, and 78-2319/20 filed simultaneously herewith, the orders confirming and consummating the Plan of Reorganization will be affirmed.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1697 and 78-2313

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

BANKERS TRUST COMPANY, as trustee under the New York Central and Hudson Railroad Company Consolidation Mortgage dated June 20, 1913,
Appellant

(D. C. No. B-70-347 In Bankruptcy)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Present: ALDISERT, GIBBONS and HIGGINBOTHAM,
Circuit Judges *

JUDGMENT.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the orders of the said District

* Judge Aldisert heard argument in this appeal, which was consolidated with others, but did not participate in its decision.

Court confirming and consummating the Plan of Reorganization at district court numbers 3455 and 3707 be, and the same are hereby affirmed. Costs taxed against appellants.

ATTEST:

THOMAS F. QUINN
Clerk

January 11, 1979

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1703, 78-2311 and 78-2312

In the Matter of:
PENN CENTRAL TRANSPORTATION CO., DEBTOR;

WILMINGTON TRUST CO., etc.,
Appellant

Nos. 78-1699, 78-1700 and 78-2315

In the Matter of:
PENN CENTRAL TRANSPORTATION CO., DEBTOR;

MANUFACTURERS NATIONAL BANK OF DETROIT, etc.,
Appellant

OPINION ON PETITION FOR REHEARING AND REHEARING EN BANC

(Opinion filed February 26, 1979)

Present: ALDISERT, GIBBONS and HIGGINBOTHAM, *Circuit Judges* *

PER CURIAM

We have before us petitions for panel rehearing and rehearing en banc filed by the Wilmington Trust Com-

* Chief Judge Seitz and Judges Adams, Rosenn, Hunter, Weis and Garth did not participate in the consideration of this matter.

pany, indenture trustee for the Michigan Central Collateral Bonds, and Manufacturers National Bank of Detroit, indenture trustee for the Lake Shore Collateral Bonds. While their arguments differ in their details, the thrust of the claims is identical. Both indenture trustees rely upon the holding of this court in the R & I appeal that rental income from the Park Avenue properties which had been diverted to pay operating expenses during the reorganization remained subject to the lien of the R & I mortgage and must therefore be recognized in the Plan's allocation of reorganization securities to R & I bondholders. That holding, the indenture trustees contend, increases by approximately $60,000,000 the value of the assets that are subject to their senior mortgages on the same properties. The effect of this substantial increase in the value of those assets, they argue, is to increase the likelihood that the assets securing their claim would have survived a litigated liquidation. Therefore, under the logic of our opinion in the *Irving Trust Appeals,* the distributions to them under the Plan must be increased to meet the requirements of the absolute priority rule.

We have no occasion to consider the merits of these claims. In this appeal neither the Wilmington Trust or Manufacturers National Bank made any objection in their briefs or at oral argument to the diversion of the Park Avenue rentals, even to the extent of adopting by reference the arguments made by the Bank of New York on behalf of the R & I bondholders. Nor did either indenture trustee rely upon the availability of such assets in the extensive liquidation analyses presented to this court. Manufacturers National Bank of Detroit argues that the failure to raise or even hint at the indenture trustees' objection to the diversion of the Park Avenue rentals was intended to avoid wasteful duplication of argument on appeal. Our examination of the Reorganization Court record, however,

discloses that even in that court neither trustee objected to the treatment of the Park Avenue rentals or mentioned their relevance to their proposed liquidation analyses either in their final statement of objections to the Plan *or* in the briefs which they filed in opposition to the Plan. Having failed to raise this issue at any prior stage of the proceedings, these trustees may not at this late date claim that the failure of the reorganization court to consider the value of Park Avenue rentals in the liquidation analysis of their claims was error. The petition for rehearing is therefore denied.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1699, 78-1700 and 78-2315

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

MANUFACTURERS NATIONAL BANK OF DETROIT, Indenture Trustee under the Lake Shore Collateral Indenture,
Appellant

Nos. 78-1703, 78-2311 and 78-2312

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

WILMINGTON TRUST COMPANY, as Successor Indenture Trustee under the New York Central and Hudson River Railroad Company, Michigan Central Collateral Indenture dated April 13, 1898,
Appellant

SUR PETITION FOR REHEARING.

Present: ALDISERT, GIBBONS and HIGGINBOTHAM, *Circuit Judges* *

The petitions for rehearing filed by Manufacturers National Bank of Detroit and Wilmington Trust Company

* Chief Judge Seitz and Judges Adams, Rosenn, Hunter, Weis and Garth did not participate in the consideration of this matter.

in the above entitled cases having been submitted to the judges who participated in the decision of this Court and, there being no other circuit judges of the circuit in regular active service not recused in these cases, and no judge who concurred in the decision having asked for rehearing, the petitions for rehearing are denied, in accordance with the opinion of this Court.

ATTEST:

THOMAS F. QUINN
Clerk

Dated: February 26, 1979

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-2311/12

In the Matter of: Penn Central Transportation Co., Debtor; Wilmington Trust Co., etc., *Appellant*

SUR PETITION FOR REHEARING.

Present: ALDISERT, GIBBONS and HIGGINBOTHAM, *Circuit Judges.**

The petition for rehearing filed by Wilmington Trust Co., etc., Appellant in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied. The court having entertained two petitions for rehearing by the appellant it is ORDERED that no further petition for rehearing will be entertained.

By THE COURT,

ALDISERT
Judge

Dated: March 22, 1979

* Chief Judge SEITZ and Judges ADAMS, ROSENN, HUNTER, GARTH and WEIS did not participate in the hearing or rehearing of this appeal.

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor.

In re
OPINION APPROVING PLAN OF REORGANIZATION.

No. 70-347.

United States District Court,
E. D. Pennsylvania.

March 9, 1978.

Order Approving the Plan
March 17, 1978.

Charles A. Horsky, Brice M. Clagett, Philip R. Stansbury, J. Michael Hemmer, Wesley S. Williams, W. Crosby Roper, Jr., Jeffrey S. Berlin, Wynne M. Teel, Eric A. Eisen, John E. Heintz, Covington & Burling, Washington, D.C., James J. Howard, Carl Helmetag, Jr., Terrence M. Quirin, Philadelphia, Pa., John F. Bomster, John F. Corrigan, Providence, R.I., John J. Ehlinger, Jr., Robert Szwajkos, Philadelphia, Pa., for Penn Central Trustees.

White & Williams by John Francis Gough, Philadelphia, Pa., for Brown Brothers Harriman and Co., et al., The Cleveland Trust Co., City of Indianapolis, et al.

Becker, Ross & Stone by Stephen E. Michelman, New York City, for Sterling National Bank and Trust Co. of New York.

Leon Leighton, Scarsdale, N.Y., for Minority Stockholders at Mahoning Coal.

Winthrop, Stimson, Putnam & Roberts by Stephen A. Weiner, Fredrick I. Miller, New York City, for Irving Trust Co.

Ballard, Spahr, Andrews & Ingersoll by Frederic L. Ballard, Frederick W. Clark, Vincent Hatton, Philadelphia, Pa., for the Girard Bank.

Duane, Morris & Heckscher by Henry T. Reath, Reeder R. Fox, Gene E. K. Bruton, Philadelphia, Pa., for New England Merchants National Bank.

Ropes & Gray by David L Thomas, Jr., Boston, Mass., for New England Merchants National Bank.

Edith I. Spivack, New York City, for the City of New York.

Sullivan & Worcester by Joseph Auerbach, Morris Raker, Boston, Mass., for Richard Joyce Smith, Trustee, New Haven Railroad.

James William Moore, New Haven, Conn., for Smith, Trustee of the New York, New Hampshire and Hartford Railroad.

Shearman & Sterling by George J. Wade, Robert H. Mackinnon, Kenneth M. Kramer, Michael K. Diana, New York City, for Cikhank, N.A., as agent for the Committee of Secured Bank Creditors.

Willkie, Farr & Gallagher by Louis A. Craco, Walter H. Brown, Jr., Thomas L. Bryan, Michael B. Targoff, New York City, for Institutional Investors Penn Central Group.

John J. Degman, Atty. Gen. of N.J. by Herbert K. Glickman, Barry D. Szaferman, Douglas G. Sanborn, Dep-

uty Attys. Gen., Trenton, N.J., for the State of New Jersey.

Proskauer, Rose, Goetz & Mendelsohn by Philip M. Hahn, New York City, for the Bank of New York as Indenture Trustee.

Dahlberg, Mallender & Gawne by John J. Iseman, Birmingham, Mich., for Manufacturers National Bank of Detroit.

Kohn, Savett, Marion & Graf by Stuart H. Savett, Robert A. Swift, Philadelphia, Pa., for Consolidated Edison Co., Philadelphia Electric Co., Pennsylvania Power & Light, Baltimore Gas & Electric Co., Duquesne Light Company and Evans Products Co.

Pepper, Hamilton & Scheetz by Laurence Z. Shiekman, Teresa R. Novick, Philadelphia, Pa., for Consolidated Rail Corp., Excelsior Truck Leasing Co., Pennsylvania Truck Lines, Merchants Dispatch Transp. Co.

Lipper, Lowey & Dannenberg by Richard B. Dannenberg, New York City, Nemser & Nemser by Stanley Nemser, New York City, David Berger, P.A. by Daniel Berger, Philadelphia, Pa., and David Berger, Philadelphia, Pa., for Robinson petitioners.

Fell, Spalding, Goff & Rubin by William P. Quinn for Trailer Train Co.

Krusen, Evans & Byrne by Thomas A. Bell, Philadelphia, Pa., for American Dredging Co., Burroughs Corp. and Dresser Industries, Inc.

White & Case by Ted Neuenschwander, John E. Osnato, New York City, for Bankers Trust Co.

Rogers & Wells by William R. Glendon, Donald F. Luke, New York City, for the Committee of Interline Railroads.

Clark, Ladner, Fortenbaugh & Young by Edward C. Toole, Jr., Philadelphia, Pa., for the Committee of Interline Railroads.

Douglas MacGillivray, Bellefontaine, Ohio, for Ohio's County Treasurers and Local Taxing Authorities.

United States Railway Association by Gearold L. Knowles, for United States Railway Association

Dechert, Price & Rhoads by Alfred W. Cortese, Jr., Philadelphia, Pa., for Amoco Oil Co., Ashland Oil, Inc., Exxon Co., U.S.A., Shell Oil Co., The Standard Oil Co. (Ohio) and Texaco, Inc.

Friedman, Medalie & Ochs by Alvin Friedman, Washington, D.C., for Union Bank of Los Angeles.

U. S. Dept. of Justice by John H. Broadley, Washington, D.C., for United States.

Reavis & McGrath by Leonard M. Leiman, Lawrence W. Boes, New York City, for Special Representatives Noyes Leech and Robert H. Mundheim.

Grant G. Guthrie, Washington, D.C., for Securities and Exchange Commission.

Tyler, Reynolds & Craig by H. Theodore Cohen, Boston, Mass., for Charles S. Jeffrey.

Schnader, Harrison, Segal & Lewis by Gilbert W. Oswald, Philadelphia, Pa., for Penn Central Co.

Schnader, Harrison, Segal & Lewis by David S. Hope, Philadelphia, Pa., for First National Bank of Chicago, et cetera.

Schnader, Harrison, Segal & Lewis by Gilbert W. Oswald, David S. Hope, Philadelphia, Pa., for AT&T and its subsidiaries, General Motors Corporation, Syntonic

Technology, Incorporated, Federal Transportation Company, Frank and Vincent Visceylia, Federal Storage Warehouses and Peddie Buildings.

Jaffin, Schneider, Conrad & Wertheimer by George M. Jaffin, New York City, for Carret & Co., et al.

Wolf, Block, Schorr & Solis-Cohen by Michael L. Temin, Philadelphia, Pa., for First Pennsylvania Bank, N.A.

City of Pittsburgh by D. R. Pellegrini, Grace S. Harris, Pittsburgh, Pa., for the City of Pittsburgh, County of Allegheny.

Harold H. McLean, Pittsburgh, Pa., for Earl E. Barton, Betty Barriger, John W. Barriger, Stanley Barriger, Margret Henderson, Arthur M. McLean, Harold H. & Sarah N. McLean, Hugh C. and Katherine McLean and Ann Salyard.

Hepburn, Ross, Willcox & Putnam by Herbert G. Schick, Philadelphia, Pa., for Philadelphia & Trenton, Union of Baltimore, Northern Central, Michigan Central, Pittsburgh, Youngstown & Ashtabula.

Goodman & Ewing by William H. Ewing, Joseph J. Connolly, Philadelphia, Pa., for The Connecting Railway Co., Trustee John C. Kohl, Fairfax Leary, Trustee of the United New Jersey Railroad & Canal Co.

Kelley, Drye & Warren by Edward Roberts, III, New York City, for Manufacturers Hanover Trust Co.

Henry Fogler, pro se.

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FULLAM, *District Judge*.

PART I

A. INTRODUCTION

The Trustees of the Penn Central Transportation Company, Debtor, have presented for approval a Plan of Reorganization for that company and 15 Secondary Debtors whose lines were a part of the Penn Central system. These related documents are generally referred to collectively in these proceedings as "the Plan." I have concluded that, subject to a few relatively minor adjustments, the Plan complies with all legal requirements, is feasible, fair and equitable, and should therefore be submitted to the vote of the participants. The Opinion which follows sets forth the reasons for those conclusions.

The Opinion deals with a great many issues and the contentions of a large number of litigants. The reader will encounter certain recurring themes, because the same legal concepts, or the necessities of a certain set of circumstances, may have important, but slightly different, bearing upon the issues being decided in a variety of contexts. Every effort has been made to avoid unnecessary repetition, but in some instances reprise seemed preferable to constant cross-references.

In anticipation of the hearings on the Plan, this Court extended an invitation to the Securities & Exchange Commission to review the proposed Plan and comment upon it. This was done because the traditional role of the Interstate Commerce Commission in railroad reorganization proceedings has been abrogated by statute, with respect to the Northeastern bankrupt railroads subject to the RRRA. The SEC graciously responded to the Court's invitation, and its Report has provided very valuable assistance to the Court and to the parties.

The SEC Report has been particularly helpful with respect to feasibility issues and what may be referred to as the legitimacy of the new securities proposed to be issued pursuant to the Plan. I am satisfied that the SEC's valuations, and its conclusions concerning feasibility are sound. I incorporate herein the elaboration of these issues contained in the SEC Report, and have concluded that further discussion of feasibility and valuation issues in this Opinion would be superfluous.

The excellent sketch of the pre-bankruptcy history of the Debtor which is included in the SEC Report has also made it unnecessary to repeat that material here.

Because of the unavoidable length and complexity of the Opinion, I have provided at the outset a brief summary of the contents, for the benefit of those who are more interested in the decision of a particular issue than in the legal reasoning leading to that decision.

B. Summary of Opinion

The Opinion begins by explaining what a reorganization is, and how it occurs. This is followed by a review of the history of the Penn Central reorganization proceedings from June 21, 1970 to date. In combination, these opening sections of the Opinion point up the unique problems for this estate stemming from the implementation of the RRRA: the existence of huge amounts of unpaid administration claims against the estate, and the fact that the rail assets have been conveyed to ConRail but have not yet been paid for.

Next, a summary of the Plan itself is provided. This section begins with an explanation of how the Plan attempts to deal with the uncertainties stemming from the RRRA-related problems. This is followed by a detailed description of the significant terms of the new securities to be issued under the Plan, and the proposed distribution of those securities. The section concludes with an explanation of the relationship between the Penn Central Plan and those of the Secondary Debtors.

The next section contains a discussion of the compromise aspects of the Plan. The principal conclusions are that a reorganization plan may be achieved at this time without finally litigating all of the many disputed legal and factual issues; that it is permissible to incorporate in a reorganization plan compromise resolutions of disputed issues, regardless of whether the compromises are agreed upon by all of the affected parties, so long as the resolution is fair and reasonable, within the range of results which litigation could be expected to provide, and in the best interests of the affected parties. The major compromise settlements embodied in the Plan—with the Federal Government, the secured bank group, and the New Haven Trustee—are then discussed and approved.

The following section contains a summary of the principal issues involved in the Valuation Case litigation before the Special Court, the status of that litigation, and its relationship to the provisions of the Plan.

The balance of the Opinion deals with objections to various features of the Plan which have been expressed by the litigants. Section II-F deals with the claims of state and local taxing entities. In summary, the Court concludes that penalties should be disallowed, that tax claims need not be paid in full in cash; that the lien of tax claims against the rail assets conveyed to ConRail are not automatically transferred to the Debtor's retained assets; and that the Plan makes adequate provision for these claims.

Section II-G deals with the Plan's provisions relating to the claims of secured creditors (Class J), and with a number of objections to that treatment. The conclusion is that the claims of secured creditors are properly classified

in a single class, and are accorded fair and equitable treatment under the Plan. The various arguments of the so-called "super-secured" claimants (creditors whose claims are more than fully secured by retained assets) are discussed, and rejected for the most part; but the Court has concluded that slightly different treatment should be provided the claims of bondholders under four specified mortgages (Mohawk & Malone; Gold Bond; New York Central 6% due 1990; Penn Central 6½% Bonds due 1993). Specifically, their rights to redeem their preference stock are to have priority over the random-selection-by-lot redemptions for other Class J creditors.

The Opinion then deals with various disputes concerning the manner in which retained assets have been allocated among various mortgages for purposes of establishing the correct allocations of A and B bonds under the Plan. The Court rejects most of the objections against the Plan but does require a slight revision in the allocation of retained assets to the R & I Mortgage in recognition of the denial of recourse against properties sold by the Debtor before bankruptcy and not released from the mortgage.

The remaining objections of Class J creditors are discussed and overruled, with minor exceptions. The Court agrees with the contention of Girard Bank as Indenture Trustee of the Pennsylvania Railroad General Mortgage that the after-acquired property clause renders that mortgage a lien on certain disputed branch lines.

Section II-H of the Opinion discusses the claims for priority under the so-called "six months" rule and under the "necessity of payment" doctrine. The conclusion is that the six months priority cannot be recognized in this proceeding, because there is no "current debt fund" and because there have been no diversions for the benefit of mortgagees. And the Court concludes that the "necessity of payment" doctrine does not apply at this time.

Section II-I deals with claims for priority asserted by Bank Setoff claimants, the interline railroads, and claims for freight loss and damage. All of these claims for priority treatment are rejected.

Finally, the Opinion deals with the contingent claims asserted by Amtrak and ConRail, and with certain miscellaneous claims of the Federal Government, and concludes that the Plan contains adequate provisions for these claims.

Part II

A. Background

1. Reorganization Process

Federal bankruptcy law addresses the problems of financially embarrassed business debtors, and provides solutions which fall into two general categories: (1) liquidation, or "straight" bankruptcy, in which the assets of the debtor are sold and the proceeds distributed to its unsecured creditors in proportion to the amounts of their claims, whereupon all debts are discharged and the debtor can start anew [1]; and (2) rehabilitation through reorganization of the enterprise.[2] Generally speaking, if there is a reasonable prospect that the debtor can become successful, so that greater economic benefits would be realized by preserving it as a going concern than would be achieved through liquidation, then rehabilitation rather than liquidation is the correct choice.

Railroads, however, are in a special category, both because the public interest requires that they continue to operate, and because dismantling and liquidating them would ordinarily be economically wasteful, and would be unlikely to provide as great a return to their creditors as would their preservation as operating units. Congress

1. Chapters I through VII of the Bankruptcy Act.

2. Chapter X of the Bankruptcy Act.

has therefore precluded railroads from availing themselves of the "straight" bankruptcy liquidation alternative, but instead has enacted the special provisions of § 77 of the Bankruptcy Act for the rehabilitation of railroad debtors.[3] The Penn Central bankruptcy proceeding is a § 77 railroad reorganization proceeding.

Assuming it makes economic sense to keep the enterprise going—that is, assuming the value of its earning power is greater than the amount which would be produced by sale of its assets—reorganization of the enterprise is feasible. Reorganization is achieved through the mechanism of a Plan,[4] which translates the value repre-

3. As will be developed in the next section of this Opinion, § 77 of the Bankruptcy Act has been modified and supplemented, in the course of these proceedings, by enactment of the Regional Rail Reorganization Act of 1973 (RRRA) and its amendments.

4. A railroad reorganization plan must conform to § 77(b), which provides:

> (b) "A plan of reorganization within the meaning of this section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, interest on unfunded debt, amortization of discount on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; (5) shall provide adequate means for the execution of the plan, which may include the transfer of any interest in or control of all or any part of the property of the debtor to another corporation

sented by the earning power of the enterprise into a new set of securities, and distributes these new securities appropriately among creditors and other claimants, in discharge of the debtor's obligations. Valuation of the enterprise involves at least two exercises of judgment: determining what the earning power of the enterprise realistically is (based upon past performance, present circumstances, and supportable predictions of future events), and establishing the appropriate capitalization rate for converting the predicted future earnings into present value.

The design of the capital structure of the reorganized enterprise must be such that the debtor's earnings will support the new capital structure. The reorganized company must be reasonably likely to be able to comply with the requirements of the securities issued. That is, it must be reasonable to suppose that the reorganized company will be able to meet when due the payments required by the new debt securities, and that it will have sufficient

4. (Cont'd.)

or corporations, the merger or consolidation of the debtor with another corporation or corporations, the retention of all or any part of the property by the debtor, the sale of all or any part of the property of the debtor either subject to or free from any lien at not less than a fair upset price, the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein, the satisfaction or modification of any liens, indentures, or other similar interests, the curing or waiver of defaults, the extension of maturity dates of outstanding securities, the reduction in principal and/or rate of interest and alteration of other terms of such securities, the amendment of the charter of the debtor and/or the issuance of securities of either the debtor or any such other corporation or corporations for cash, or in exchange for existing securities, or in satisfaction of claims or rights or for other appropriate purposes; and may deal with all or any part of the property of the debtor; may reject contracts of the debtor which are executory in whole or in part, including unexpired leases; and may include any other appropriate provisions not inconsistent with this section."

earnings to enable it to pay dividends and grow, so that its equity securities will have value.

By definition, if the Debtor were able to pay off its existing debt obligations according to their terms, it would not be in bankruptcy. Thus, the new securities provided for in a reorganization plan inevitably represent substantial alterations in the rights of creditors and other claimants.

In a straight liquidation proceeding, the assets would be sold and the cash divided among the unsecured creditors, subject to priorities established by statute. All claims would be discharged, even though the proceeds from the sale of the Debtor's assets proved insufficient to pay all claims in full, or even left many claims unpaid altogether. By the same token, in a reorganization proceeding we are dealing with a finite quantity of values (the total value of the ongoing enterprise represented by the new securities, or cash plus new securities) to be distributed among creditors and other claimants. The essential requirement is that the distribution be fair and equitable, and in accordance with the absolute priority rule.

Under the absolute priority rule, all claims against the estate must be classified and ranked in accordance with the system of priorities established by law. The claims in each class must receive the fair equivalent of the rights lost through discharge, if there is to be any distribution to claimants of lesser rank. This does not mean that senior claimants must be paid in cash before junior claimants participate, nor does it mean that distributions to junior claimants must be made at later times than to senior claimants. But what is required is that the distributions to senior claimants must have value which is substantially equivalent to the value of the claim being surrendered, before claims of lower rank can be recognized.

Generally speaking, there are four classes of claims: claims of administration (*i.e.*, the costs and expenses in-

curred in conducting operations during bankruptcy), secured claims, unsecured claims, and equity interests. To the extent that a secured claim is not fully secured (that is, to the extent the assets securing the claim are worth less than the amount of the claim), it is treated as an unsecured claim. If the total amount of the claims against the estate exceed the total value of the estate, the estate is insolvent, albeit still reorganizable, and equity interests cannot be permitted to participate under the plan.

A § 77 Plan of Reorganization must be submitted to the Court for approval.[5] If approved as fair and equitable, and as complying with all legal requirements, the Plan must then be submitted to the vote of all who are entitled to participate in the Plan. If the vote is favorable,[6] the

5. Section 77(e) establishes the standards for approval of a plan:

> "After . . . hearing, and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; (2) the approximate amounts to be paid by the debtor, or by any corporation or corporations acquiring the debtor's assets, for expenses and fees incident to the reorganization, have been fully disclosed so far as they can be ascertained at the date of such hearing, are reasonable, are within such maximum limits as are fixed by the Commission, and are within such maximum limits to be subject to the approval of the judge; (3) the plan provides for the payment of all costs of administration and all other allowances made or to be made by the judge, except that allowances provided for in subsection (c), paragraph (12) of this section, may be paid in securities provided for in the plan if those entitled thereto will accept such payment, and the judge is hereby given power to approve the same."

6. Under § 77 voting is by amount of claim. A class accepts a plan if two-thirds of the total amount of claims voted are cast for acceptance.

Plan is then confirmed by the Court, and carried out. If one or more classes of participants reject the Plan, the Court will review the matter in light of the results of the voting, but the Court is empowered to confirm the Plan notwithstanding the negative vote, in the absence of changed circumstances, if it deems that course appropriate.

If the Court initially disapproves the Plan, it is not submitted to vote; the Court may require that a new Plan be submitted, or may dismiss the proceedings.[7]

The Penn Central Plan is now before the Court for approval. The Court is required to decide whether the Plan conforms to legal requirements, whether it is feasible and whether it is fair and equitable.

2. History of the Penn Central Reorganization

The Penn Central reorganization differs from the 'normal' railroad reorganizations of the past in many ways. The immediately apparent difference, of course, is the magnitude of the enterprise and the complexity of its financial structure; but these are only matters of degree. The really important differences in kind have become manifest during the course of the proceedings, and require some explanation, as a prelude to our examination of the proposed Reorganization Plan.

If a bankrupt railroad can be sufficiently revitalized so that it becomes income-producing again, it can be reorganized. In previous railroad reorganizations, the question whether the enterprise could be restored to profitability depended upon changes in the economic climate, or changes within the control of management (*e.g.*, cost reductions, increases in efficiency, etc.). The successful

7. Dismissal of a § 77 reorganization proceeding would presumably result in some form of liquidation of the enterprise, in further judicial proceedings similar to the equity receivership proceedings utilized before § 77 was enacted.

reorganizations of the past were generally achieved because a combination of changed economic circumstances and management improvements provided sufficient net income to support a scaled-down and stretched-out debt structure.

In instances where it proved impossible to achieve profitability, there were several alternatives. Merger into larger, profitable, railroads could sometimes provide a solution to the problem. Or, preservation of essential rail service could be achieved by selling major portions of the bankrupt railroad to other, profitable, carriers, and the remaining assets could be liquidated. Or, in rare instances, the bankrupt railroad could simply be shut down and liquidated, with only temporary and localized adverse consequences to the public.

In the case of Penn Central, however, it early became apparent that profitability could not be restored by means within the control of the Trustees or of this Court. Very substantial changes in the regulatory climate, both procedural and substantive, were required, and sweeping changes in work rules and other aspects of labor-management relations bearing upon productivity. Some of these changes could theoretically have been brought about without further legislation by Congress. For example, greater flexibility in rate-making, more expeditious and more equitable divisions proceedings, and expedited proceedings for abandonment of unprofitable lines, were theoretically attainable through the actions of regulatory agencies.[8] And the labor-management issues were theo-

8. While theoretically possible, this was a practical impossibility. For example, when a district court held that environmental impact statements were required in abandonment proceedings, the ICC declined to hold hearings on all abandonment applications until the Supreme Court decided the appeal. And a major divisions dispute which had been in litigation for 15 years was dismissed because the record was stale.

retically susceptible of resolution through the mechanisms provided by the Railway Labor Act.[9] But the changes needed here would have ramifications far beyond the Penn Central system itself; important issues of national transportation policy were at stake. Hence, as a practical matter, congressional action was essential.

Thus, in the case of Penn Central, restoration of profitability which would render reorganization feasible was dependent upon governmental action. And many of the alternatives to independent reorganization which had provided acceptable solutions in other railroad reorganizations were simply not available to Penn Central because of its size, the magnitude of its problems, and the importance of its rail service to the nation's economy. For example, merger with another railroad was out of the question, and cessation of operations was unthinkable.

The other major distinction between the Penn Central reorganization and earlier reorganizations, namely, the accumulation of huge amounts of unpaid administration expenses, is a product of the passage of time before legislative action occurred, and the nature of the legislative actions taken.

The historical review which follows shows how these problems developed, and puts in chronological perspective the genesis of the proposed Plan of Reorganization.

From the first day of the Penn Central reorganization, June 21, 1970, the full powers of § 77 were brought to

9. When the lengthy procedures mandated by the Railway Labor Act have been exhausted without successfully resolving the controversy, management is free to promulgate the work rule changes, and labor is free to strike. Once that position is reached, as it was in this case in February 1973, and a strike is called, as it was in this case, the public interest in avoiding disruptions in rail service inevitably leads to a legislative solution, as it did in this case. On February 9, 1973, the President signed a Senate Joint resolution abrogating the Trustees' work rule changes and mandating continued operation under the old arrangements while Congress addressed the overall problems of the rail industry.

bear. Pursuant to various Orders of this Court, the Trustees suspended all tax payments, leased line rents, and debt service, and all creditors' actions against the estate were stayed.[10] Notwithstanding the substantial reduction in expenses which resulted from these actions, there was inadequate cash available to continue operations. A federal guarantee provided $100 million from the issuance of trustees certificates and the entire amount was used to pay operating expenses during the early months of the case.[11]

While the immediate cash shortage problem was working its way to resolution, the Trustees endeavored to cut costs and increase demand for the Debtor's services. They made some progress and predicted additional progress. Yet, on February 10, 1971, the Trustees reported to the Court: [12]

> Penn Central is presently locked by circumstances beyond its managerial control into a situation which had best be recognized *now* as completely precluding viability unless certain constraints are removed, or other arrangements are made to compensate for their effects. (Emphasis in original.)

The Trustees identified four conditions for viability: (1) elimination of losses on passenger service; (2) rationalization of freight plant through elimination or subsidy of uneconomic lines; (3) more flexible rate and division procedures; and (4) improved labor productivity. The Trustees properly observed with respect to these conditions:

10. Order No. 1.

11. *In re Penn Central Transp. Co.*, 325 F. Supp. 302 (E.D. Pa. 1971).

12. Doc. No. 857.

It is appreciated that the conditions to Penn Central's viability are hard and introduce factors that go far beyond the normal boundaries of railroad reorganization proceedings under § 77. But in the firm opinion of the Trustees, nothing less has a chance.

In September of 1971, the Trustees filed a further report. Progress had been made in improving the internal operations of the railroad, and the enactment of the Amtrak statute had resulted in a substantial diminution, but not elimination, of the estate's non-commuter passenger service losses.[13] Between September of 1971 and January of 1972, the Trustees completed a series of economic studies, and in February of 1972, reported their conclusion that unless the conditions of viability were substantially met by the end of 1973, the estate could not be reorganized.[14] On the positive side, the Trustees also reported that their studies indicated that there was within the 20,000 route miles of the Penn Central system a core freight railroad of about 11,000 miles which carried approximately 80% of the traffic, and which would be a viable economic entity if certain labor practices were changed. However, the projected revenues of this core railroad would be inadequate to absorb the continuing losses under the Amtrak contract and from commuter operations. In sum, at the very early stages of the case the basic question was clearly drawn. Would the private and public institutions whose cooperation was essential to the attainment of the conditions of viability embrace the proposal for an 11,000-mile core railroad?

On April 1, 1972, the Trustees filed a proposal for a Plan of Reorganization which spelled out in more specific

13. Doc. No. 1828.

14. Doc. No. 2637.

terms the justification for and the method of implementing the core railroad concept.[15] In October of 1972, the Trustees again reported their belief that the core railroad concept was appropriate but suggested increasing the size of the core to 15,000 miles.[16] The reasons for this change were that reduction to the 11,000-mile core would not generate sufficient cash to pay the labor severance expenses which would flow from the concomitant reduction of the work force; and that the ICC's procedures for abandonment of rail lines would be inadequate to handle, within a reasonable time, the abandonment applications which would be necessary to reduce the system to the 11,000-mile core. The October 1972 report also contained an analysis by the Trustees of a variety of measures, short of outright nationalization, which would be necessary if the core system and the conditions of viability were not attained.

In February of 1973, the Trustees again, eschewing nationalization, but apparently reconciled to the inevitability of delay before the conditions of viability could be achieved, concluded that plant improvement in the range of $600 to $800 million would be necessary and that the only source of this financing was the United States. Absent such capital investment even a sharply reduced freight system would not be viable.[17]

The dilemma facing the Trustees was that each day the estate operated, additional deferred charges were accruing. Time was expensive. High administration expenses gave rise to two concerns. First, the potential economic viability of any railroad which might emerge was diminished by each increase in high-priority obligations.

15. Doc. No. 3033.

16. Doc. No. 4428.

17. Doc. No. 5053.

Second, the continued accrual of administrative expenses would soon reach the point of being an unconstitutional impairment of the rights of the estate's creditors.

During this early period this Court resolved virtually every question presented to it in such a way as to give the Trustees an opportunity to preserve the railroad. After all, that is the purpose of § 77. The problems came to a head in early 1973, as the April 1, 1973 deadline for the filing of a Plan of Reorganization approached. On March 6, 1973, I filed Memorandum and Order No. 1137, granting an extension of time for filing a Plan, but directing the Trustees, not later than July 1, 1973, to file either a Plan of Reorganization or their proposals for liquidating the enterprise. In the course of that Memorandum I made the following observations.[18]

> It has long been apparent that the particular problems of Penn Central cannot be completely divorced from problems of national transportation policy. Railroads are, after all, a regulated industry. However unappealing may be the notion that a regulated industry can become bankrupt, the Trustees' efforts to rehabilitate the Debtor are circumscribed by existing statutes and regulations. To the extent that these statutes and regulations, whether in the area of abandonment, tariffs, or resolution of labor disputes, preclude the exercise of self-help in achieving profitability, the legislative and executive branches of government must be looked to for solutions, if solutions are to be forthcoming.
>
> And this is as it should be, for it is those branches of government which should determine whether the kind of railroad which could emerge from a private income-based reorganization would be consistent with long-range goals of national transportation policy. Such matters as how much rail transportation should be provided, how much competition among railroads is desirable in the Northeast, and the extent of public interest in maintaining rail service which cannot be operated profitably, are clearly beyond the province of the Trustees, the other parties to this reorganization, and this Court.
>
> I take judicial notice of the fact that the legislative and executive branches are now addressing themselves to these problems. . . . It would obviously be premature, therefore, for this Court to make final determinations as to the future course of this reorganization proceeding on the basis of the existing legislative and regulatory framework. The legal and constitutional rights of the parties to this reorganization should be evaluated in the light of whatever changes Congress sees fit to enact.
>
> By the same token, however, this Court cannot ignore the realities of the Debtor's situation. On the basis of the record to date, it appears highly doubtful that the Debtor could properly be permitted to continue to operate on its present basis beyond October 1, 1973.

18. *In re Penn Central Transp. Co.*, 355 F. Supp. 1343, 1345-46 (E.D. Pa. 1973).

In July of 1973, the Trustees submitted a Plan of Reorganization which contemplated termination of rail operations and liquidation of rail properties unless arrangements were made with public authorities to assume interim losses.[19] That Plan contemplated that public agencies, and other carriers, would have preference in the bidding for the rail properties, and that service would be

19. Doc. Nos. 5926, 5927.

continued under interim operating agreements until ICC and Court approvals of any purchases could be obtained. Non-rail real estate was to be spun off into and managed by a new real estate company. Finally, after consummation of the sales of the rail property, the remaining rail assets would be conveyed to a real estate company. When and how the creditors would be compensated was left open. The Commission concluded, after extensive hearings, that the Trustee's Plan was not a "plan" within the meaning of § 77 because it did not provide concretely for the continuation of rail services.[20] The Commission specifically declined to take into account the evidence before the Commission relating to the unconstitutionality of continued loss operations, holding that that issue was exclusively for the courts. The Commission referred to the legislation then under preliminary consideration in the Congress as perhaps the appropriate solution to Penn Central's problem.

In order to trace the efforts of the Congress to formulate a response to Penn Central's financial plight and that of the other bankrupts in the Northeast portion of the country, it is necessary to return to February of 1973. One step in the Trustees' efforts to achieve their conditions of viability was the implementation of far-reaching work rule changes which, after exhaustion of the Railway Labor Act procedures, were promulgated on February 8, 1973. The United Transportation Union immediately called a strike. With the trains at a standstill, Congress enacted Senate Joint Resolution 59 on the same day and the President signed the resolution into law on the next. As a result of this congressional action, the work rule changes were suspended and service resumed promptly. The Congress also directed the Department of Transportation to file a

20. 347 ICC 45 (1973).

comprehensive report setting forth the Department's views "for the preservation of essential rail transportation services in the Northeast section of the country." The Department and the ICC filed reports on March 26, 1973, which by and large agreed that the conditions of viability set forth by the Trustees were correct, and recommended procedures for creating a new core freight system. However, both the Department and the Commission saw a broader need, the consolidation of the Northeast bankrupt carriers into one or more new rail systems.

From March of 1973 to the end of that year, the Congress was engaged in the process of drafting and enacting legislation designed to remedy the Northeast rail crisis. On January 2, 1974, the Regional Rail Reorganization Act of 1973 (RRRA) became law.[21]

The broad outline of the RRRA is relatively straightforward. The bankrupts would operate under the aegis of the Reorganization Courts for a further period, approximately 20 months, during which time the United States Railway Association (USRA), a new corporate entity created under the Act, could complete the task of planning the new rail system or systems, and deciding what portions of the Northeast bankrupts' rail facilities should be conveyed to Consolidated Rail Corporation (ConRail), the company which was to take over the system which USRA designed. The statute contemplates a system which, while not profitable immediately, would ultimately be a profitable private sector carrier. In return for the properties conveyed to ConRail, the bankrupts were to receive common stock and other securities of ConRail in amounts commensurate with the value of the properties conveyed. The Act also created the Special Court, a three-judge panel selected by the Judicial Panel

21. 45 U.S.C. §§ 701-794.

on Multidistrict Litigation, to rule on the adequacy of USRA's valuation of the conveyed property and the value of the stock of ConRail which was given in return.

Before a debtor in a § 77 reorganization could be subjected to the regimen of the RRRA, the presiding reorganization court had to find the debtor was not reorganizable under § 77, or, if it was, that the public interest would be best served by reorganization under the RRRA. With respect to Penn Central and a number of the Secondary Debtors, I concluded that they were not reorganizable under § 77.[22] As to certain other Secondary Debtors, I found that, although they were reorganizable under § 77, the public interest would best be served by their reorganization under the RRRA.[23] Shortly after these preliminary decisions were handed down, a three-judge court (of which I was a member) held the RRRA unconstitutional.[24] Although that Court found a number of the plaintiff's key contentions premature, it concluded that the failure to provide a mechanism for compensating the estates for unconstitutional erosion between the time of the passage of the Act and the conveyance to ConRail rendered the Act unconstitutional.

The next sequence of judicial review occurred pursuant to the RRRA. This Court found that the processes of the Act were not "fair and equitable," and an appeal was taken to the Special Court.[25] At about the same time

22. *In re Penn Central Transp. Co.*, 382 F. Supp. 831 (E.D. Pa. 1974).

23. *In re Penn Central Transp. Co.*, 382 F. Supp. 851 (E.D. Pa. 1974).

24. *Connecticut Gen. Ins. Corp. v. United States Ry. Ass'n*, 383 F. Supp. 510 (E.D. Pa. 1974), *rev'd sub nom., Regional Rail Reorganization Act Cases*, 419 U.S. 102, 95 S. Ct. 335, 42 L. Ed. 2d 320 (1974).

25. *In re Penn Central Transp. Co.*, 382 F. Supp. 856 (E.D. Pa. 1974).

the three-judge court's judgment was appealed directly to the United States Supreme Court.

The Special Court reversed this Court's decision on the grounds that unconstitutional erosion of the estates, if any, would be compensable under the Tucker Act.[26] Shortly thereafter, the United States Supreme Court reversed the three-judge court's finding that the Act was unconstitutional.[27] The Supreme Court's two essential findings were (1) that the securities of ConRail were a constitutional medium of exchange for the properties conveyed, because the Tucker Act provided a remedy to satisfy any difference between the constitutional minimum value of the property conveyed and the value of the ConRail securities, and (2) that any unconstitutional erosion of the states which occurred prior to the conveyance of the properties to ConRail could also be compensated under the Tucker Act. The upshot of all this was that the RRRA, as supplemented by the potential Tucker Act remedy, was held constitutional.

The Preliminary System Plan was filed on February 27, 1975, and the Final System Plan on July 26, 1975. The end result of the planning process was that the service and trackage of the competing Northeast bankrupts was trimmed somewhat and consolidated into one system to be operated by ConRail.

Throughout this period, the parties faced the problem of maintaining rail services until the conveyance date. There was almost constant litigation in the reorganization courts concerning the implementation of the § 213 grant program and the § 215 improvement program, the statutory mechanisms for providing cash necessary to continue

26. *In re Penn Central Transp. Co.*, 384 F. Supp. 895 (Special Ct. 1974).

27. *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 95 S. Ct. 335, 42 L. Ed. 2d 320 (1974).

rail operations.[28] That litigation aside, the Trustees and the respective Federal agencies joined in the cooperative effort to insure that the transfer of the Debtor's properties to ConRail went smoothly.

Before the conveyance of the properties took place, however, Congress made a number of important amendments to the RRRA. Of primary importance to the consideration of the Plan are § 306 of the Act, which authorized the issuance of Certificates of Value, and the § 211(h) loan program.[29]

Section 306 Certificates of Value are interest-bearing USRA securities backed by the full faith and credit of the United States, redeemable on December 31, 1987 (but potentially callable earlier). The certificates are a pledge of the United States to make up with cash any difference between the net liquidation value of the assets conveyed by Penn Central and the other Northeast bankrupts, and the value of ConRail's stock and other benefits conferred on the estates by the RRRA. Recourse to the Tucker Act would, however, be necessary if the Special Court should find that the constitutional minimum value of the assets conveyed exceeds the net liquidation value of the assets.

As the conveyance date approached, it became clear to all that even after all funding provided under §§ 213 and 215 was exhausted, Penn Central's payables would far exceed its receivables as of the date of conveyance. The situation was potentially tantamount to a second bankruptcy, since ConRail was not to assume any liability for Penn Central's pre-conveyance obligations. And ConRail's operations might be adversely affected if the bills remained unpaid. Section 211(h) was enacted to remedy

28. *See, e.g., In re Penn Central Transp. Co.*, 395 F. Supp. 567 (E.D. Pa. 1975); *In re Penn Central Transp. Co.*, 400 F. Supp. 920 (E.D. Pa. 1975).

29. 45 U.S.C. §§ 746, 721(h).

this situation. It created a mechanism by which ConRail borrowed from USRA in order to pay certain classes of the Debtor's payables. In turn, the estate was obligated to recognize as a current cost of administration the amount of § 211(h) funds expended by ConRail on the estate's behalf.

On April 1, 1976, the Debtor's rail properties designated in the Final System Plan were conveyed to ConRail. Of the retained rail lines, some are being operated under RRRA-funded subsidy agreements with state and local governmental entities.

As a consequence of all this, the Debtor's estate now consists of real estate and other investments not acquired by ConRail, plus the eventual right to receive ConRail securities (backed by USRA Certificates of Value) in exchange for the Debtor's rail assets conveyed to ConRail.

B. Summary of the Plan

1. Introduction

The presence of huge amounts of unpaid administration claims (represented in large part by the claims of the United States Government, for which Congress has mandated the highest possible priority) and the unanswerable questions concerning the amount and timing of the receipt of the consideration for the rail properties conveyed to ConRail, have greatly compounded the difficulties inherent in fashioning a Plan of Reorganization of this magnitude. In my 1974 Opinion dealing with the so-called "180-day" issues under the RRRA, I had occasion to anticipate (but not resolve) these problems:

> Another problem relating to valuation is the lack of any mechanism for establishing a relationship between the values to be assigned to the rail properties conveyed, and the valuation of the interests of se-

cured creditors holding liens against those properties. There are several facets to that problem. In the first place, the timing is off. In determining whether a plan of reorganization is fair and equitable, it is necessary to determine the extent to which particular groups of creditors are secured, and the value of their respective securities, so as to be sure that they will receive equivalent value before any junior classes of claimants participate. Since the exchanges under RRRA would be between Conrail and the Debtor's estate, rather than the creditors, the problem of later recognition of the correct treatment of the creditors in a reorganization plan would be rendered quite difficult.

Moreover, the valuation of the property for sale to Conrail might very well not be on a basis which would permit rational allocation of the consideration on a segment-by-segment basis for purposes of later assigning lien values. And that difficulty would itself be greatly magnified by the fact that Conrail will presumably be made up of parts of various existing railroads, blended together in a smaller system designed to handle the traffic now being handled by several different railroads.

A further difficulty with the statute is the lack of precision in defining what 'other benefits of the Act' are to be taken into account as part of the purchase price for the rail properties conveyed to Conrail.

In re Penn Central Transp. Co. (180-Day Decision Under § 207(b)), 382 F. Supp. 856, 865 (E.D. Pa. 1974). The Plan now before the Court is the product of the Trustees' Herculean and, in my judgment, successful, efforts to surmount these difficulties.

The problems would be easily resolved if the value of the assets remaining in the Trustees' hands after the

conveyance to ConRail were sufficient to satisfy all claims against the estate. Unfortunately, the facts are otherwise. The assets remaining on hand are valued at almost $1.85 billion, but the principal amount of all claims against the estate totals more than $3 billion. Therefore, any reorganization plan which is to be consummated before 1987 (the anticipated conclusion of the Valuation Case) must distribute securities based in part upon the anticipated proceeds from the Valuation Case, and must also take into account the correlative, albeit theoretical, risk that there will be no proceeds.

The assets remaining after conveyance to ConRail fall into two principal categories: (1) Penn Central's ongoing, successfully operating, non-railroad business enterprises, principally consolidated in the Pennsylvania Company (Pennco); and (2) a variety of real estate and other investments. The key business judgment reflected in the Plan is that Pennco is a sound company with growth potential, and that it is in the best interests of all concerned to make Pennco the nucleus of the reorganized company. The soundness of this business judgment is amply supported in the evidentiary record, and is unquestioned.

The Plan contemplates that most of the other assets (herein referred to collectively as the "retained assets") will be liquidated in an orderly fashion during the next 10 years pursuant to an Asset Disposition Program. This is a very detailed and carefully constructed plan of liquidation, and there is reasonable certainty as to the amount and timing of the fruits of that program.

Pursuant to the conventional reorganization process outlined in Section II–A above, the first step is to arrive at a value for Pennco and the other retained assets. The next step is to determine what claims are secured by those assets, and in what amount; this step includes ap-

plying marshalling principles. The final step is to establish a feasible capital structure and to design a fair and equitable scheme of distribution. It is at this final step that the Valuation Case must be taken into account.

The Trustees have integrated the known values of Pennco and the retained assets with the unknown value of the proceeds from the Valuation Case in two ways: First, the various securities to be issued under the Plan are related primarily, and in some cases exclusively, to either the Asset Disposition proceeds, the value of the reorganized company, or the proceeds of the Valuation Case. Second, in determining an appropriate distribution scheme, the Trustees made two essential assumptions: (1) that the Debtor is solvent; and (2) that each secured creditor has a lien upon assets equal in value to the amount of his claim (principal and interest). If the Valuation Case should produce a very small recovery, the assumption of solvency would be incorrect, and the assumption of full security would be incorrect in many instances. But if a more favorable result is achieved in the Valuation Case litigation, both assumptions would be clearly correct. Since the record does not permit a finding of insolvency, and indeed it seems more probable than not that the estate is solvent, I am satisfied that the Trustees' assumptions represent the proper course of action.

The Plan provides for the issuance of securities in various combinations designed to recognize the differing characteristics of each class of claims, and to achieve a fair and equitable distribution of both the known values and the risks and potential rewards of the Valuation Case litigation.

The new securities to be issued under the Plan consist of four series of secured notes—A through D; Series E unsecured notes; two series of general mortgage bonds—A and B; preference stock; common stock; and certificates

of beneficial interest (CBI). In addition, the reorganized company will assume the outstanding trustees certificates (due in 1986) which will have a first lien on all of its assets.[30] Administration claimants receive the secured notes or a combination of cash and secured notes; secured claimants receive the so-called "10-triple-30" package (10% cash, 30% mortgage bonds, 30% preference stock, and 30% common stock); unsecured creditors receive a combination of CBIs and common stock; and the Penn Central Company, the sole owner of the Debtor's stock, receives common stock (10% of the total).

Two of the securities, the Series B general mortgage bonds and the preference stock, are convertible to common stock under certain circumstances.

The rights of the respective securities to cash from the Asset Disposition Program and other sources are rather complex. Therefore, in connection with the discussion of the securities, frequent reference will be made to the Trustees' 11-year cash forecast.[31] Having a reasonable estimate of when the securities are scheduled to be paid makes it easier to understand the complicated rights of each security in relation to the other securities issued under the Plan.

2. *New Securities and Their Distribution*

Series A Notes: These notes are an escape valve to be issued only if needed to pay approximately $56 million

30. The Trustee's certificates in default will be paid on consummation.

31. Exhibit to affidavit of Ernest Varalli, Doc. No. 14434. Neither Mr. Varalli's cash forecast nor the figures used by the Court contemplate the issuance of any C-2 notes. *See* Section II-J for discussion of the claims which may be satisfied with C-2 notes. In discussing the various lien priorities of the securities issued under the Plan, generally no mention is made of the liens of the Trustees Certificates due in 1986 or Series A notes because it is contemplated that the Trustees Certificates will be paid on maturity and that no A notes will be issued.

now due on the defaulted trustees certificates or to make scheduled principal payments on Series B notes. Cash is already on hand to pay the defaulted trustees certificates and cash flow should certainly be adequate to meet the payments on the Series B notes. There is, as the SEC Report has observed, therefore no need to consider the Series A notes in this analysis.

Series B Notes: Approximately $350 million face amount of these notes are to be issued to satisfy the claims of the United States arising from its advances in that amount under § 211(h) of the RRRA. All interest on these notes is deferrable until December 31, 1987, when the principal and accrued interest are payable without any provision for extension. Interest will be compounded semi-annually at a rate slightly above the Treasury's cost for 10-year borrowings. The Trustees estimate the rate will be 7½%. B notes will have a lien on the reorganized company's assets subject only to the lien of the 1986 trustees certificates and any outstanding Series A notes, and will also have a similar lien on the proceeds of the Valuation Case. Moreover, between 1978 and 1981 the outstanding principal of the Series B notes must be reduced by at least $80 million and under certain circumstances an additional, but limited, reduction of principal must be made. If the Valuation Case concludes before the B notes mature, the notes become payable to the extent that funds are available. The net effect of the Series B notes is to postpone payment of most of the priority claims of the United States Government until termination of the Valuation Case, permitting the use of cash and the proceeds from the Asset Disposition Program to satisfy the claims of other creditors.

The Plan contains an important covenant which protects the B notes. Pennco may not dividend to the reorganized company more than 50% of its consolidated net

earnings. As a result, until the Series B notes are paid, there will be a substantial cash buildup in Pennco. This covenant insures the adequacy of the security which will be available to satisfy the Government first lien on the reorganized company.

The cash flow forecast contemplates aggregate payments on B notes of $100 million by 1981 ($20 million more than the amount required). If this forecast is correct, at maturity the total outstanding obligation on the B notes will be $579 million, consisting of $249.8 million in principal and $329.2 million in accrued interest.

Series C, D, and E Notes: These notes together with some cash, will be distributed to state and local tax authorities to satisfy pre- and post-petition taxes, including interest but excluding penalties, totaling $451.5 million. Forty-four percent of each tax claim will be paid within two years: 26.4% in cash at consummation, and 17.6% in Series D serial notes which mature during that period. The remaining 56% of each claim will be paid with a combination of Series C-1 notes, and D term notes which mature in December of 1987. As will be more fully described below, under certain circumstances, the principal of the C-1 notes will be converted to either D term notes or E notes, or a combination of both.

The original allocation of D term notes and C-1 notes depends on the extent to which the tax claims accrued on conveyed or retained property. Basically, tax claims are segregated into two classes: (1) real estate taxes assessed on conveyed property; and (2) real estate taxes assessed on retained property plus all other taxes. C-1 notes are distributed in an amount equal to 56% of the total tax claim on conveyed property and D term notes are distributed in an amount equal to 56% of the total tax claims attributable to retained property. By way of illustration, assume a tax claim of $40 on conveyed and $40 on retained assets with

$10 in accrued interest on each. The tax claimant receives (subject to certain rounding principles) $26.40 in cash; $17.60 in Series D serial notes; $28 in C-1 notes; and $28 in D term notes. In the aggregate, $131.2 million in C-1 notes and $121.6 million in D term notes will be issued.

Both the D term and serial notes are general secured obligations of the reorganized company, carry a 7% interest rate payable semi-annually, and have a claim to the Valuation Case proceeds subordinate to the B and C notes. Approximately $79.5 million in D serial notes will be issued, one-half payable on December 31 of 1978 and the remainder on December 31, 1979. Payment of the principal and interest of the D serial notes is to be from the asset disposition proceeds, subject only to the prior claim of the B notes. The maturity date of the $121.6 million in D term notes which are to be issued originally under the Plan is December 31, 1987, but if these notes are not redeemed on that date, they are automatically extended for five years with pro rata redemption in each year of the extension period. Between consummation and the redemption date, $85 million in interest will be paid on the D term notes.

C notes will be issued in two series, C-1 and C-2. C-2 notes are reserved for Class G creditors.[32] Except for an important conversion provision applicable only to the C-1 notes, C-1 and C-2 notes have the same terms. Both series mature on December 31, 1987, and interest, which is deferred until maturity, accrues at 8% compounded annually. Although the C notes are not general obligations of the reorganized company, the interest and principal of the C notes, in that order, have a claim against the Valuation Case proceeds subject only to prior claims of the B notes. Any portion of the interest or principal of the C

32. *See* Section II-J for a discussion of the claims that may be satisfied with C-2 notes.

notes which is not paid from Valuation Case proceeds is extinguished.

There is, however, a rather complex conversion scheme which applies only to the principal of the C-1 notes which may remain outstanding after application of Valuation Case proceeds. Depending on the exact amount of the Valuation Case proceeds, the principal of the C-1 notes will convert to either D term notes, E notes, or a combination of both. The table below shows the treatment of principal and interest of C-1 notes for various amounts of 1987 Valuation Case proceeds and comparable 1976 base values.

Valuation Case Proceeds 1987	*Base Values 1976*	*Treatment of C Notes (in millions)*
$447 or less	$181 or less	All C-1 interest cancelled All C-1 principal to E notes
$447-$578	$181-$234	All C-1 interest cancelled Mix of D term and E notes
$579	$234	All C-1 interest cancelled All C-1 principal to D notes
$579-$731	$234-$296	C-1 interest paid to extent Valuation Case proceeds exceed $579 All C-1 principal to D notes
$732-$862	$296-$349	All C-1 interest paid Some C-1 principal paid and remainder converted to D notes
$862	$349	All C-1 interest and principal paid

If the Valuation Case proceeds (1987) are between $447 million and $578 million, the allocation of D term notes and E notes is computed as follows: C-1 notes convert to E notes in an amount equal to the amount of B notes outstanding after application of the Valuation Case proceeds, and the balance of the C-1 notes convert to D term notes. By way of illustration, assuming $500 million in Valuation Case proceeds (1987), the balance due on B notes is

$79 million and that amount of C-1 notes is converted to E notes with the remaining principal of the C-1 notes, $52.2 million ($131.2 million less $79 million), converted to D term notes.

The integration of D term notes issued as a result of conversion of C-1 notes with the original D term notes requires some fine tuning. If the Valuation Case is concluded before December 31, 1987, and some or all of the C-1 notes are converted to D term notes, the conversion issue of D term notes will share *pari passu* with the original D term notes and be subject to the automatic five-year extension. However, if the Valuation Case is concluded after December 31, 1987, but before December 31, 1991, the D term notes issued in conversion of C-1 notes will be payable in equal amounts so as to retire the entire conversion issue by the end of 1992. The last but, it is hoped, unnecessary provision of the conversion scheme is that if the Valuation Case is concluded on or after December 31, 1991, the principal of the C-1 notes is immediately payable in cash on the later of December 31, 1992, or the conclusion of the Valuation Case.

Series E notes are fully subordinated unsecured obligations of the reorganized company which do not bear interest and mature on the later of December 31, 1993, or six years after the conclusion of the Valuation Case. In the event any E notes are outstanding on the maturity date, there is an automatic 10-year extension. E notes do have the benefit of a cumulative redemption covenant under which a maximum of $30 million a year in E notes may be retired. Payments will be made on the E notes only if cash is available, and then only to the extent the earnings of the reorganized company, subject to certain adjustments, exceeded $50 million in the previous year.

General Mortgage Bonds: Two series of general mortgage bonds—Series A and Series B—are to be distributed

in various combinations to secured creditors to satisfy 30% of each secured creditor's claim. The mortgage bonds have the benefit of a complicated set of priorities as to the funds available to make principal and interest payments. For present purposes, all that need be noted is that the bonds are subordinate to the notes as to lien priority and cash availability, and as between the two series, the principal and interest of A bonds must be paid before Asset Disposition proceeds may be used to service the B bonds. Both series bear a 7% per annum interest rate beginning on April 1, 1981, but if cash is not available, the interest is deferred and compounded semi-annually. The maturity date for the bonds is December 31, 1987, but if the Valuation Case is not concluded as of the maturity date, there is an automatic 10-year extension. With respect to the Valuation Case proceeds, the B bonds are paid first, but in the event that the Valuation Case proceeds are inadequate to satisfy the B bonds, any remaining amount of principal is converted into common stock at the same number of shares per thousand dollars as the unsecured creditors received per thousand dollars of claim (estimated to be 11.40 shares per thousand dollars). On the other hand, A bonds are general obligations of the reorganized company, and if the Valuation Case proceeds are inadequate to satisfy the A bonds, they must be paid either at maturity or pursuant to the terms of the automatic extension. The cash forecast indicates that A bonds will be retired easily from the Asset Disposition Program.

Early redemption of the mortgage bonds is controlled by two separate provisions of the Plan. Mortgage bonds have a very high claim to Asset Disposition proceeds, and to the extent all prior claims to Asset Disposition proceeds are met in any given year, there will be mandatory early redemption of the mortgage bonds. However, the Plan

puts a limit on the mandatory redemption feature by establishing the following maximum percentages of the total amount of mortgage bonds which may be redeemed as of any given year: 1978—33.34%; 1979—44.45%; 1980—55.56%; 1981—66.67%; 1982—77.78%; 1983—88.89%; 1984—100%. Because A bonds must be paid first, the actual A bond redemption limitation for 1978 is 55%, with an additional 18.3% cumulatively thereafter until all the A bonds are redeemed. If the cash forecast is correct, $304.9 million of the $344 million in A bonds will be paid by 1980 and the remainder will be paid by 1983, and $25.1 million in B bonds will be paid in 1983 and most of the accruing B bond interest will be paid through 1987.

Preference Stock: Secured creditors will receive non-dividend preference stock, computed at a ratio of 1 share per $20 of claim, for 30% of their claim. Of the 30 million preference shares authorized, it is expected that 28.36 million will be issued to secured creditors. Each share will have two-thirds of a vote, and the aggregate preference shares will represent 45% of the voting power of the reorganized company. Since secured creditors will also receive 12.73 million shares of common stock, which has one vote per share, the secured creditors as a class will have 75% of the voting power.

Beginning in 1981, annual redemption of 5% of the preference stock at $20 per share is required if an income test is met. If the income test is met but cash is not available, the redemption obligation carries over. The cash forecast does not indicate that any preference stock will be redeemed. However, the forecast does show that the income test would permit redemption of $25.3 million of preference stock in 1981. Since no estimate of Pennco's earnings past 1981 is available, additional redemptions cannot be predicted. Unredeemed preference stock will

have a claim against the proceeds of the Valuation Case subordinate to the Series B, C, and D notes and the Series B bonds. If the Valuation Case proceeds are not adequate to redeem the preference stock, preference stock automatically converts to common at a ratio of 1 share of common for each 6.5 of preference.

Certificates of Beneficial Interest: It is estimated that $213.2 million in Certificates of Beneficial Interest will be issued to satisfy 30% of the unsecured claims. The certificates are payable only out of the Valuation Case proceeds which are available after the satisfaction of the secured notes, general mortgage bonds and preference stock.

Common Stock: Of the 40 million shares of common stock which are authorized under the Plan, 23.153 million are to be originally issued: Secured creditors—12,734,562 shares (55%); unsecured creditors—8,103,813 shares (35%); and Penn Central Company—2,315,375 shares (10%). However, due to the provisions of the Plan which preclude the issuance of fractional shares the stock issued on consummation will be somewhat less than the shares allocated to the class. The difference in shares between the full allocation and the amount issued will be sold to the public within one year, and the proceeds distributed to those who would have received the fractional shares. Conversion of the full amount of B bonds and preference stock would require issuance of 6.9 million additional shares of common. Any Valuation Case proceeds in excess of the amount necessary to satisfy Series B, C, and D notes, Series B mortgage bonds, preference stock, and certificates of beneficial interest, will of course benefit the common stockholders. Mr. Guest, the Trustees' investment advisor, has opined that the reorganized company may be able to pay modest dividends on the stock dur-

ing the 1978-87 period and that it would be wise for the directors to declare such dividends.

The first Board of Directors will be selected from persons representing the Institutional Investors, the PCTC Indenture Trustees, the secured banks, the New Haven Trustee, unsecured creditors, the Penn Central Company and two designated officers of the reorganized company. As the staggered terms expire, the shareholders will elect replacements. Beginning on the sixth anniversary of the consummation of the Plan all directors will be elected for one-year terms by cumulative voting. Thus, the voting shareholders will have substantial control over the choices to be made by the reorganized company.

In sum, the Plan creates a set of securities which weave an intricate series of claims against the three asset groups. Cash and Asset Disposition Program proceeds are distributed to the United States, tax claimants, and secured creditors. Valuation Case proceeds are subject to the essentially same priority scheme, the United States, tax claimants, and the B bonds of secured creditors, and any remaining proceeds are available to satisfy the secured creditors preference stock, then the CBI's of the unsecured creditors, and ultimately the shareholders. The reorganized company is to be owned by the secured creditors, the unsecured creditors and Penn Central Company, but subject to all of the liens created by the Plan.

3. Scope of the Plan

The prior discussion has proceeded, for the purpose of clarity, as if there were only one debtor, Penn Central Transportation Company. This, of course, is not the case. Only about one-half of the rail lines of the Penn Central system were actually owned by Penn Central. The other half were leased to Penn Central under long-term leases by so-called leased line lessors. Fifteen of

these lessor companies have filed § 77 petitions as part of the Penn Central proceedings and are referred to as the Secondary Debtors. For each of the Secondary Debtors, the Penn Central Trustees have proposed a Plan. Subject to a number of exceptions, the treatment of the bondholders of the Secondary Debtors is the same as that of the bondholders of Penn Central. Stockholders are, however, treated quite differently. The respective leases between Penn Central and the Secondary Debtors require Penn Central to pay as rent certain dividends to the public stockholders of the Secondary Debtors. For the purposes of the Plan, the annual stock dividend payment is capitalized at a rate of 10 and the resultant amount is treated as a secured claim which receives the same distribution as other secured creditors, the 10-triple-30 securities package. Implementation of the Penn Central and Secondary Debtor Plans would have the effect of placing control of the Secondary Debtor's assets, including their subsidiaries, in the reorganized company. The cash forecast assumes that all of the Secondary Debtors' Plans will be effectuated. A major purpose of proposing Plans for the Secondary Debtors at this time is to achieve a substantial simplification of the debt and equity structure of Penn Central and its related lessor companies. Consummation of all the Plans would eliminate more than 50 separate mortgages of Penn Central and the Secondary Debtors, and the outstanding stock of Penn Central Company and the Secondary Debtors. In sum, the Plan would replace the complex debt and equity structure of Penn Central and the Secondary Debtors with the comparatively streamlined and simple debt and equity structure of the reorganized company which is described above.

There is another group of lessors which are not in bankruptcy. The Trustees originally appeared to be including these companies under the Plan and treating their

debt and equity interests substantially the same as the Secondary Debtor bondholders and equity holders. Later, the Trustees clarified their position as being merely an offer by the Trustees to settle all outstanding accounts with the lessors on the terms mentioned. Failing prompt acceptance, settlement negotiations were to be initiated. To date, no such settlements have been presented to the Court. However, the cash forecast is predicated on the assumption that all of the non-bankrupt lessors accept the proposed settlements. Since the failure to accept the Trustees' settlement proposal reduces the assets available to the reorganized company but also reduces the amount of securities to be issued, it does not appear that feasibility of the Plan would be impaired by the failure of the non-bankrupts to join in the Plan. The Trustees have offered evidence that the feasibility of the Plan would not adversely be affected by the failure to have these matters resolved before consummation, and no one has challenged that conclusion. It should be noted, however, that the eventual resolution of the disputes between the reorganized company and the non-bankrupt lessors may be either more or less favorable to the Trustees than the terms of the Plan.

C. The "Compromise" Features of the Plan

In order to achieve this Plan, the Trustees have negotiated compromise settlements with the Federal Government; the group of banks holding the pledge of all of the stock of Pennco; the New Haven Trustee; and others. Unless these compromise settlement arrangements—particularly those with the Federal Government and the bank group—are approved as reasonable, there can be no Plan of Reorganization.

Before discussing the reasonableness of each of the major compromise proposals, it is well to have clearly in

view the legal standards which must govern the Court's judgment in the matter. It is firmly settled that a Plan may be approved which embodies compromise resolution of conflicting contentions, if the approval is based upon an informed evaluation of the strengths and weaknesses of the respective contentions, the likelihood, duration and expense of litigation which would otherwise be necessary, and the range of probable litigation results. *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 88 S. Ct. 1157, 20 L. Ed. 2d 1 (1968). Where the Trustees and particular parties have in fact reached a compromise settlement of their conflicting contentions, those are the governing criteria.

Essentially the same criteria are applicable in instances where no actual compromise agreement has been reached, but the Plan nevertheless resolves the dispute, *i.e.*, where the Trustees have in effect proposed a compromise resolution of the controversy, and ask the Court to approve and implement it as being fair and reasonable.

In both situations, approval of the suggested resolution of the controversy may substantially affect the interests of others who are not direct parties to the compromise, or to the negotiations and discussions which produced the agreed-upon or suggested solution. It is therefore necessary that all affected parties have an opportunity to be heard.

A hypothetical example may be useful here. Assume creditor X asserts a claim for $1 million, but the Trustees contend that the estate's liability is only $500,000. Assume further that if creditor X is allowed more than $600,000 from the estate, there will not be enough left in the estate to pay creditor Y in full. The Trustees and creditor X agree to settle the claim for $750,000. Creditor

Y is, of course, entitled to be heard on the fairness and reasonableness of the compromise. But if, after a full opportunity for all concerned to present both evidence and argument, the reorganization court is satisfied that the proposed compromise is fair and reasonable in light of the strengths and weaknesses of the contentions of creditor X, the Trustees, and creditor Y, the costs and delays litigation would involve, and the range of probable outcomes of litigation, the Court may approve a Plan which embodies that compromise resolution. The fact that creditor Y was not a party to the settlement, and did not participate in the negotiations which produced it, is immaterial. His rights are fully vindicated in the hearing process. The objective tests of fairness and reasonableness are controlling.

Ordinarily, if the only item in dispute is the correct amount of a claim, there would be no occasion for the Trustees to propose a compromise resolution which was not agreed to by the creditor directly involved; it would be simpler to have the claim summarily adjudicated pursuant to the program for proofs of claim. But when more complicated disputes arise, as they inevitably do in any complex reorganization case, what amounts to a compromise resolution of a dispute must often be proposed in the absence of actual agreement between the parties directly involved. The words uttered by the Supreme Court a century ago still ring true today:

> Railroad mortgages . . . are peculiar in their character and affect peculiar interests. The amounts involved are generally large, and the rights of the parties oftentimes complicated and conflicting. It rarely happens that a foreclosure is carried through to the end without some concessions by some parties from their strict legal rights, in order to secure advantages that could not otherwise be attained, and which it is supposed will operate for the general good of all who are interested. This results almost as a matter of necessity from the peculiar circumstances which surround such litigation.

Fosdick v. Schall, 99 U.S. 235, 252, 25 L. Ed. 339 (1878).

The Plan now before the Court incorporates a host of compromises of various kinds. They include actual compromise settlement agreements; provisions of the Plan which carry out what the Trustees regard as a fair and reasonable adjustment of unresolved disputes; and underlying assumptions, concerning such matters as the Valuation Case, based upon judgments which have been arrived at through a process closely akin to compromise. The agreed-upon or proposed compromise settlements include disputes between the Trustees and particular claimants or classes of claimants regarding the amount or nature of the claims, and disputes between classes of creditors. Included in the former category is the important proposal that the complex relationships between Penn Central and the 15 Secondary Debtors be resolved by cancelling all mutual claims, paying off the public holders, and treating the Secondary Debtors' assets as assets of Penn Central. An illustration of the compromise resolution of a dispute between classes is the treatment of tax claims. In such cases, each party to the dispute receives less favorable treatment than would be appropriate if all disputed issues were resolved in its favor, but more favorable treatment than would be appropriate if it should litigate and lose.

The distinction between settlement agreements and compromises which have not actually been agreed upon (a distinction which, as discussed above, is not crucial for present purposes) is sometimes difficult to draw. The

compromises of the claims of the United States Government, the Pennco pledge dispute, the claims of the Secondary Debtors, and the claims of the New Haven Trustee have all been expressly agreed upon. On the other hand, there is not unanimous agreement by the taxing authorities concerning the treatment of state and local tax claims, although most such claimants who have participated actively in the Plan proceedings now support the Plan.

The compromise-like assumptions related to the Valuation Case problem stem from the fact that neither the amount to be received by the estate in exchange for the rail properties conveyed to ConRail, nor the timing of its receipt, is now known. Thus, any Plan proposed before the Valuation Case litigation is concluded must take these uncertainties into account; the assumptions must be within the reasonable range of probable litigation results. As discussed in detail in Section II-B, the Plan deals with the uncertainties of the Valuation Case through the issuance of a mix of securities designed to reflect both the risks and the potential rewards of the Valuation Case.

While each compromise settlement, compromise proposal and compromise-type assumption must be evaluated individually, the importance of viewing the Plan as a cohesive unit cannot be over-emphasized. All of the compromises are closely interrelated. In a very real sense, the Plan is the sum of all of its compromises. The fairness and equity of the treatment accorded to any class or member thereof must be evaluated in the context of the Plan as a whole.

To recapitulate, a reorganization court unquestionably has the power to approve a plan which embodies compromise resolutions of disputed issues notwithstanding the objections of persons directly or indirectly affected by the compromises. This does not mean that legitimate contentions may be disregarded. Rather, they must be taken

into account in determining whether the Plan does or does not provide fair and equitable treatment. The issue is not merely whether there are objections to a particular compromise, but whether the objections are persuasive. No one creditor or group of creditors can be permitted to insist upon litigating every contention to finality, if that very process would frustrate a reorganization which is in the best interests of all creditors.

Perhaps the most striking feature of the Plan proceedings has been that, notwithstanding the welter of objections, counter-proposals, charges and counter-charges, it appears that no one has consciously advocated abandoning the attempt to achieve a Plan of Reorganization at this time. And there is almost equally unanimous agreement on the proposition that retention of Pennco as the operating core of the reorganized company is essential. As an assessment of the economic realities of the situation, this business judgment is undoubtedly sound, as noted in the SEC Report. In view of the ramifications, intended or unintended, of some of the arguments presented, however, the Court must initially consider whether present approval of a Plan of Reorganization, with its attendant compromises, unfairly prejudices senior creditors whose claims might otherwise be more promptly satisfied. Arguably, if that were the case, the Plan should not be approved, no matter how globally beneficial it might be.

At first blush, it would seem theoretically possible to simply liquidate all retained assets immediately, pay the proceeds to top-ranking claimants in descending order of priority, await the outcome of the Valuation Case, and then complete the liquidation process by distributing the proceeds as far down the priority ladder as they would reach. While this course of action would undoubtedly produce less total benefit for the creditors than would a Reorganization Plan, it would theoretically produce more immediate

payment to the senior creditors whose claims are entitled to priority treatment.

Upon analysis, however, it becomes immediately apparent that in the absence of compromise, even that simplistic and draconian result could not be achieved any more speedily than a Plan of Reorganization which provides greater benefits for all. The reason lies in the nature and complexity of the legal issues which, in the absence of compromise, would have to be litigated.

In their evidentiary submission, the Trustees have spelled out in some detail the major sources of potential litigation. These include the disputes concerning the relative priority of governmental claims, state, local and federal; the validity of the Pennco pledge agreement; a host of issues concerning the coverages of various mortgages and the correct application of marshalling principles; and what is perhaps the most significant but least understood problem, unraveling the intricate relationships between the Debtor and the Secondary Debtors. And even if these disputes could be finally resolved through litigation by the early 1980s, as the Trustees assume, there is another aspect of the matter which the Trustees appear to have somewhat underestimated. All of these disputes are interrelated. Generally speaking, the highest-priority claims must be finally resolved before distribution to lower classes could begin. For that reason, until the highest-priority claims are known, it is virtually impossible to determine correctly the treatment which lower classes of claims should receive. It is unlikely, therefore, that litigation of all of these major disputes could efficiently be pursued simultaneously. Stated otherwise, if the litigation proceeded simultaneously, it might well be necessary, upon completion of one round of litigation, to commence an entirely new round of litigation in order to determine how the results of the first round of litigation should be implemented

(either in a Plan of Reorganization, or in the hypothetical liquidation distributions).

Until the validity and priority of the Government claims were finally determined through litigation, no distributions of any kind could be made. Until the issues surrounding the state and local tax claims were determined through litigation (Section II-F), distributions to bondholders would seem unlikely. Perhaps more importantly, until the amount of the recovery in the Valuation Case became known, it would be impossible intelligently to work through the problem of allocating unpaid administration claims among the various mortgages, rendering distribution impossible. And until the Secondary Debtor issues were resolved, those assets would not be available for Penn Central creditors.

Thus, achieving a Plan at this time would expedite, rather than delay, distributions to senior claimants as well as junior claimants, and there is no valid reason for rejecting the obvious overall economic advantages reorganization would entail.

The final, and equally obvious, point to be made is that there simply can be no reasonably prompt Reorganization Plan which does not embody compromise solutions of these litigable issues. The true choice, then, is among prompt achievement of a beneficial Plan which provides some immediate distributions to creditors and greater distributions in the long run, or holding matters in abeyance until all litigation, including the Valuation Case litigation, is concluded, and then attempting to achieve a Plan, or pursuing the economically wasteful course of a liquidation in which distributions to creditors would be withheld for many years. The choice is obvious.

Therefore, the issue is not whether the Plan should be disapproved because it embodies compromises which are

objected to, but whether the proposed compromises are fair and reasonable.

D. Major Compromises

1. United States Claims

The principal compromise settlement agreement embodied in the Plan deals with the major claims of the Federal Government. These include $50 million, plus interest, due on trustees certificates in default since 1976, and approximately $350 million due or to become due under the § 211(h) program. In addition, the Government has guaranteed the balance of $50 million in trustees certificates, which fall due in 1986.

On January 18, 1977, after hearing, I entered Order No. 2744, granting preliminary approval to the compromise arrangements which have now been embodied in the Plan. There were no significant objections to the proposed compromise at that time, and no actual objections to the terms of the compromise arrangements as such have been expressed at the present time. It is therefore unnecessary to spell out all of the details of the compromise agreement. The agreement resolves certain disputes between the Trustees and the Government concerning their respective rights and obligations under the § 211(h) program and the agency agreement with ConRail. For present purposes, the significant features are that payment of the $50 million in defaulted trustees certificates is deferred until the consummation date under the Plan, and all other claims are deferred until the conclusion of the Valuation Case; and the Government agrees to accept the distributions provided for in the Plan, and to support the Plan. Without such deferrals, there obviously could be no Plan of Reorganization, and no claims of other creditors could be paid until the Government's claims were satisfied in full.

The Government reserved the right to withdraw from the settlement agreement unless certain conditions were met. The Trustees were required to agree to pay prebankruptcy personal injury claims in cash, and to extend to state and local taxing authorities a proposal for immediate compromise settlement of tax claims (see Orders Nos. 2921, 2922 and 2929); and it was stipulated that the Reorganization Plan must provide for full cash payment of all claims under $1,000. The Trustees agreed to the arrangements for financing the Government claims which are now set forth in the Plan, and also agreed, *inter alia*, not to attempt to exercise a right of setoff based upon the estate's claims for unconstitutional erosion. The latter agreement was, of course, without prejudice to the Trustees' right to pursue those claims before the Special Court or elsewhere.

I had no difficulty in approving this compromise settlement as reasonable when the issue was first before this Court, and my opinion remains the same. The primary reason is that there is no likelihood that a more favorable result could be achieved for the estate.

No doubt there are many arguments which could be raised against the validity of the Government's claims, or at least against the super-priority they have been accorded by statute.[33]

The range of possible litigation outcomes extends from full Government victory, the consequences of which are sketched above, and full victory for the estate, in which

33. It is unnecessary to consider what tribunals might have jurisdiction over such challenges. The SEC Report (pp. 82-83) after concluding that the Special Court would have exclusive jurisdiction over such matters, seems to assert that this also deprives the Reorganization Court of jurisdiction to assess the strengths and weaknesses of the competing arguments, and the range of reasonable litigation results, in passing upon the proposal to compromise these disputes. If that is the SEC's position, I believe it is incorrect.

event conceivably the statutory prohibition against setoffs would be invalidated, and all of the Government's claims would be treated as part payment for the unconstitutional consequences of congressional treatment of the railroad, including the RRRA. Realistically, the likelihood of achieving that kind of result is not great, and the likelihood of achieving any favorable result of any kind within a reasonable span of time is simply non-existent. This was a negotiation in which the relative bargaining power of the adversaries was not exactly equal.

Apart from the timing question, some brief further discussion of the merits of the issues is perhaps justified, in view of the widespread feelings on these matters among Penn Central's creditors and stockholders.

I earlier expressed the view that requiring Penn Central to operate beyond October 1, 1973 would probably be unconstitutional. I followed very closely the development of the RRRA and, as one member of the three-judge court, agreed that it was unconstitutional in the absence of a Tucker Act remedy; and I further expressed the view that even a Tucker Act remedy would be too remote to satisfy constitutional requirements under these circumstances. The Supreme Court and the Special Court disagreed with this latter view. The RRRA, in tandem with the available Tucker Act remedy, is undoubtedly constitutional. The difficulty is that the statute as thereafter applied was quite different from the statute which was before the Supreme Court. It is conceivable that the consequences which, by amendment and other governmental actions and interpretations, have been permitted to flow from the present version of the statute, might not pass muster. But it must be recognized that constitutional challenges to governmental actions on the subject of bankruptcy have seldom been successful; the only authoritative judicial guidance as to the possible limitations of the bankruptcy power tends to

include statements to the effect that whatever those limits may be, they have not been exceeded in the particular case under discussion.

Parties unimpressed by the Government compromise must also be cognizant of the stark fact that, rightly or wrongly, bondholders and stockholders of railroad enterprises simply are not objects of sympathy in the legislative halls of this nation. Hence, even a successful assault upon the validity of the Government claims and their priority would very likely merely lead to further legislation which might generate a further round of litigation.

Having said all of this, I hasten to add that I regard the compromise agreement with the Government as a generous one. It reflects a sincere effort on the part of the Government to rectify some of the rather harsh immediate consequences of the cash-flow crisis stemming from the conveyance. It has made possible the prompt payment of personal injury claims, and at least a beginning of payment of tax claims. Whatever may be the propriety of having required the Debtor to go deeper into debt in order to provide rail service to the public during the planning and implementation of the RRRA, there is undoubted merit in an agreement to postpone collection of that additional debt so that the company can reorganize.

2. Settlement of Pennco Pledge Dispute

During the period between the merger and the bankruptcy, the Debtor obtained much of its working capital by means of a short-term, revolving credit arrangement with a consortium of banks, for whom Citibank acted as agent. Plans to achieve long-term mortgage financing did not materialize, initially because of unfavorable market conditions, and later because of the Debtor's rapidly deteriorating financial condition.

A few months before bankruptcy, the revolving credit arrangement was increased and modified. The

Debtor pledged its Pennco stock to the Citibank group as collateral for a \$300 million revolving credit authorization. Closing was held April 1, 1969. \$200 million was drawn at the time of closing; of this amount, \$100 million was used to satisfy the amount outstanding under the previous revolving credit arrangement. The entire \$300 million was drawn down before bankruptcy.

No payments have ever been made on account of this indebtedness. Treated as a fully secured claim, entitled to interest at the contract rate, the claim would now aggregate in excess of \$470 million. It would be secured by the asset—Pennco—which is absolutely essential to the success of this reorganization.

Early in the reorganization proceedings, various parties mounted a substantial challenge to the validity of the pledge of the Pennco stock. Those issues were fully litigated in connection with an earlier proposal for an amicable settlement between the Trustees and the bank group. When the proposed settlement agreement was rejected by this Court, *see In re Penn Central Transp. Co.*, 358 F. Supp. 154 (E.D. Pa. 1973) the impetus for prompt resolution of these disputes was removed. Since such matters are normally adjudicated in connection with the Plan proceedings, I was content to withhold decision in the matter, upon being advised that, for various reasons the interested parties preferred to have the pledge issues remain in abeyance.[34]

34. The Court was not made privy to the discussions, if any, which led to this informal understanding among counsel. It is fair to assume that each party considered the possible consequences of an adverse decision, the inevitability of appeals from even a favorable decision, the consequences of postponement of the decision, and the prospects for amicable resolution of the controversy. From the standpoint of the Court, the crucial consideration was the fact that preservation of the uncertain status quo would not be detrimental to any of the parties.

The validity of the pledge was challenged by various parties, with varying degrees of intensity. The Trustees themselves remained neutral on the subject. Because many of the banks involved in the transaction were also Indenture Trustees for bondholders, it was necessary to appoint Special Representatives to look after the interests of the bondholders. These Special Representatives, and representatives of equity interests (commonly referred to as "the Robinson petitioners"), were the principal proponents of the view that the pledge was invalid, although they disagreed to some extent concerning the consequences which should flow from such invalidity.

The facts giving rise to the challenge were these: Section 10 of the Clayton Act prohibits a railroad from selling its securities to any corporation having one or more directors who are also directors of the railroad, except pursuant to competitive bidding. Moreover, apart from the common director problem, transactions such as the revolving credit and pledge agreement require the approval of the ICC under Section 20a of the Interstate Commerce Act.

The transactions were structured as loans made by a small number of "lender banks"; but these lenders would then simultaneously assign part of the transactions to a large number of "participating banks". While there may be some dispute as to the extent to which the banks regarded these arrangements as legally binding among themselves, it is clear that the proposed participants were informed by Citibank from time to time as to the status of the negotiations, and that the identity of the participating banks and the amounts of their respective participations were known to Penn Central when the credit agreement was signed.

A couple of months before the final revolving credit arrangement became effective, a director of one of the

lender banks was nominated to the Penn Central Board, and was actually elected a few days before the closing, although he did not attend any directors meetings until after the closing. There was uncontradicted evidence to the effect that he was not aware of the pending loan transaction, and that the bank was not aware of his impending Penn Central directorship. He did not disclose his bank directorship to the railroad, because he misunderstood the questionnaire the railroad required him to fill out, and was not aware of the possible conflict.

In addition to this problem, it developed that five of the participating banks, who participated in the transaction to the extent of $57 million, had directors in common with the railroad throughout the relevant period. The parties were all aware of these interlocks, but assumed that they posed no problem because the participating banks were one step removed from the transactions between the Debtor and the lender banks; there were no direct negotiations or dealings between Debtor and the participating banks.

The arguments in support of the challenge may be summarized as follows: There was a clear, albeit unintentional, violation of § 10 with respect to one bank, and a violation of at least the spirit of the statute with respect to five additional banks. The Court should not countenance this transparent attempt to circumvent the competitive bidding requirements of § 10. Moreover, the failure to disclose any of these infirmities to the ICC amounted to a fraud against that agency, rendering its approval of the transaction nugatory. And, as a separate matter, the failure of the parties to disclose to the ICC the existence of "compensating balance" arrangements between the various banks and the Debtor (*i. e.*, "gentlemen's agreements" to maintain deposits at specified levels the participating banks) further undercut the legitimacy of the transaction.

On behalf of the banks, the following arguments were presented: This was not a sale of "securities" subject to § 10. In any event, a transaction of this magnitude is not realistically susceptible to competitive bidding, hence Congress could not have intended that § 10 should be applied in this context. The terms of the loan transaction were unduly favorable to the railroad. The railroad obtained the full benefit of the loan transaction, and should now be required to comply with its terms. The banks had nothing to do with the proceedings whereby the approval of the ICC was obtained. Obtaining the approval of the ICC was clearly the responsibility of the railroad; it would be unthinkable to permit the railroad to avoid a $300 million obligation by reason of irregularities in its application to the ICC. Moreover, there were no such irregularities; the structuring of the direct transaction was appropriate; the ICC must have been aware of the common practice of using the "participation" device, and certainly was aware of the universal practice of compensating balances. The compensating balance arrangements were standard, were not lived up to by the railroad, and resulted in no detriment to the railroad. None of the parties was aware of the technical violation of § 20a in the one case, and the vast majority of the participating banks were not even aware of the interlocks which necessitated the participation arrangement. None of the interlock banks participated in any way in the negotiation of the terms of the credit agreement.

Having thus summarized the contentions of the parties with respect to liability issues, I now summarize briefly the range of possible litigation results. Assuming that the debt obligations issued by the Debtor pursuant to the revolving credit arrangement were "securities" within the meaning of § 10 (an easy assumption), and that the mag-

nitude of the transaction and arguable ineffectiveness of competitive bidding do not exempt this transaction from application of the statute, it might nevertheless be concluded that the role of the participating banks does not amount to a violation of the statute, and that the technical violation should be simply ignored. Or, it might be held that the criminal penalties provided by § 10 of the Clayton Act and § 20a of the Interstate Commerce Act are exclusive, and that there is no civil liability apart from that specified in § 20a. Section 20a(11) provides that securities issued without ICC approval are void, but that securities issued in accordance with the terms and conditions of an authorization shall not be rendered void because of the failure to comply with any provision of this section. The ICC did authorize the transaction. Its decision has not been challenged (and, arguably, could not be challenged in this Court); hence the securities are valid and enforceable. Acceptance of any of these arguments would fully vindicate the pledge.

If it were concluded that the Clayton Act was violated, and that a civil remedy should be fashioned, the remedy might include cancellation of the obligation; cancellation of the obligation, leaving the banks to an unsecured pre-bankruptcy claim for unjust enrichment; depriving the banks of the fruits of the transaction which ocurred in technical violation of the Act, *i.e.*, either voiding their secured position in its entirety, or voiding their secured position to the extent of $100 million (the amount by which previously unsecured obligations were satisfied from the initial proceeds and thus converted into secured obligations): invalidating only the notes held by the conflicted lender; invalidating only the notes held by conflicted participants; invalidating the notes held by the conflicted banks and Citibank; treating the claims of the conflicted lender bank, and/or the conflicted participating banks, and/or Citibank, as unsecured, but treating the remaining claim as secured; reducing the aggregate amount of the claim by offsetting provable damages; or a combination of the foregoing.

If offsetting damages were held to be the appropriate remedy, the burden of proof would be of particular importance. It might be held that, in the absence of evidence that more favorable loan terms could have been obtained elsewhere, and in the absence of evidence that the railroad suffered any loss by reason of the "compensating balances," no damages are recoverable. Or it might be permissible to presume damages in these circumstances. A middle ground might be to conclude that, since the purpose of the competitive bidding requirement is to prevent harm to the railroad from unduly generous terms, and since the entire transaction was intentionally structured so as to avoid the competitive bidding requirements of which all concerned were well aware, the proper remedy would be to preclude recovery for any interest in excess of the prime rate at that time.

A further issue, not involved in the earlier litigation, is the extent to which the bank's claim is secured. That is, assuming the pledge is fully valid, does the amount of the claim now exceed the value of the Pennco stock? If it does, then part of the claim should be treated as unsecured; but by the same token, this would strengthen the banks' argument that they should be permitted to foreclose on the pledge, and that the administration claims, including the Government's priority claims, may not invade their interest in Pennco.

The proposed Plan embodies a compromise resolution of all of these issues. The banks' total claim is fixed at $440 million. The banks further give up any rights they may have to assert a secured position by reason of the

cash held on deposit when the bankruptcy petition was filed, or any priority arising from this Court's injunction against setoffs. With respect to the $440 million claim, the banks would receive the same treatment as other secured creditors. That is, the claim would be recognized as fully secured, but allocated as between retained and conveyed assets (61% retained, 39% conveyed).

I have no difficulty in concluding that the proposed compromise is fair. It is noteworthy that the compromise is accepted by the Special Representatives, as well as by the Robinson petitioners. The latter, of course, would have standing only if the $300 million obligation were to be voided in its entirety; that is, equity interests are affected by the totality of the debt recognized, and not by distinctions between secured and unsecured.

Because the pledge issues were fully litigated, and indeed were the subject of a lengthy adjudication prepared (but not filed) by this Court, the task of evaluating the compromise in light of the probable litigation results, at least at the district court level, is uniquely straightforward. Because the parties have resolved their differences, I do not propose to set forth in this Opinion the conclusions previously reached. It is sufficient to state that I regard it as extremely unlikely that the final outcome of the litigation would be total cancellation of the indebtedness, or total disregard of the pledge; that it would be improper simply to ignore the statutory requirements; and that the most likely outcome of litigation would have been some form of modified treatment in the Plan of Reorganization. In short, I am satisfied that the Plan provisions represent an entirely acceptable compromise of the various disputes.

3. *New Haven Trustee Claims*

The New Haven Trustee asserted a secured claim in the total amount of $208.5 million (Library Doc. J-20.1)

stemming from the inclusion of the New Haven in the Penn Central merger on December 31, 1968. The price to be paid by Penn Central for the New Haven properties was finally adjudicated by the Supreme Court shortly after Penn Central filed its reorganization petition. *New Haven Inclusion Cases*, 399 U.S. 392, 90 S. Ct. 2054, 26 L. Ed. 2d 691 (1970). The consideration was to have been principally composed of Penn Central common stock, but the New Haven reorganization court had included an underwriting provision embodying a guarantee by Penn Central that the stock would be worth $87.50 per share. No express lien was created to support that guarantee, but in view of Penn Central's bankrupty, the Supreme Court remanded the case for reconsideration of "the form that Penn Central's consideration to New Haven should properly take and the status of the New Haven estate as a shareholder or creditor of Penn Central." 399 U.S. at 489, 90 S. Ct. at 2108.

The New Haven reorganization Court imposed an "equitable lien" upon all of the former New Haven assets in the hands of Penn Central, because of what it regarded as the compelling equities of the situation. This decision was later vacated on appeal for lack of jurisdiction. In light of that litigation, and for the purpose of clarifying the status of the New Haven as a participant in the Penn Central reorganization proceedings, I concluded that the New Haven estate should be treated tentatively as holding "a lien, indeterminate in amount, and indeterminate as to priority, upon all of the real property and readily identifiable tangible personal property (exclusive of rolling stock) . . . conveyed to Penn Central" by the New Haven Trustee. *In re Penn Central Transp. Co.*, 337 F. Supp. 779, 791 (E.D. Pa. 1971). The New Haven Trustee also holds $34,025,800 of Penn Central Divisional First Mortgage Bonds secured by the properties previously owned by the

New Haven, and the New Haven Trustee has also asserted various claims based upon alleged misrepresentation or fraud on the part of Penn Central's pre-bankruptcy management (Library Docs. J-20.28-29).

The extent to which any or all of these claims, even if secured claims, are secured by retained assets, is a further subject of controversy. They are at least secured by retained assets to the extent of slightly more than $48 million and, depending upon how certain disputes concerning the New Haven's relationship to the Park Avenue properties might be resolved, may be secured by retained assets to the extent of an additional $86 million.

Under the settlement agreement, all of these disputes are resolved by according to the New Haven Trustee a secured claim in the sum of $121 million and an unsecured claim in the sum of $53 million. The settlement is well within the range of reasonably likely litigation possibilities, and the litigation would obviously be lengthy and expensive. It is significant that no one has expressed any objection to the settlement arrangement. I conclude it is fair and reasonable, and should be incorporated in the Plan.

E. The Valuation Case

1. *Status of the Valuation Case*

Pursuant to the RRRA, the Final System Plan prepared by USRA designated the properties to be conveyed to ConRail and set forth USRA's findings concerning the value of the conveyed properties and the consideration to be given in exchange. The Valuation Case is simply a *de novo* adversary proceeding [35] in which the Special

35. Section 303(c) of the RRRA does require the Special Court to give "due consideration to the findings contained in the final system plan."

Court will decide whether the terms of the exchange proposed by USRA meet the constitutional minimum standards of fairness and equity and, if not, what the terms should be to comply with that standard.

For purposes of this Opinion, it suffices to review briefly what some of the major issues are, and what decisions have thus far been expressed by the Special Court. This limited review is essential to a clear understanding of the securities distributions proposed on the Plan, and is included only for that reason. Nothing in this Opinion should be interpreted as expressing or suggesting the views of this Court as to the merits of the Valuation Case litigation.

USRA based its initial findings in the Final System Plan upon the premise that the net liquidation value of the conveyed properties was the appropriate standard for compensation. Its definition of net liquidation value was rather complex,[36] but in essence was based on two assumptions (1) that in the absence of the RRRA most of the Debtor's rail properties would have been sold to other carriers, and (2) the prices paid would have been established by the ICC at the levels which would have prevailed if there were no rail service in the Northeast at the time of the sale. On that premise, USRA assumed that the estate would be required to dismantle all rail-related physical structures and return the property to the condition it was in before dedication to rail service. For example, it assumed that all bridges and roadway electrification facilities would be removed, and all tunnels plugged. Thus, with the exception of rolling stock and salvageable rail and ties, all of the conveyed assets, in USRA's view, were to be valued at their prices for non-rail use.

36. USRA's exposition of its approach is found in Chapter 5, and the appendix thereto, of the Final System Plan.

USRA then constructed a Master Liquidation Plan hypothesizing that liquidation would have proceeded at the following pace: Year 1—18%; year 2—21%; year 3—18%; year 4—13%; year 5—10%; year 6—6%; year 7—2%; and subsequent years—10%. This projected rate of liquidation conformed to USRA's estimates of the time necessary to dismantle structures and otherwise prepare the properties for sale, and incorporated the prediction that the estate would wish to avoid saturating the market. By deducting the estimated expenses which would be incurred in the dismantling and liquidation process, USRA arrived at a net amount of proceeds to be received. The next step was to establish the date upon which such liquidation would have begun. USRA concluded that liquidation could not have commenced until after federal and state regulatory approvals were received, and fixed that date as January 1, 1979. On the assumption that the proceeds would be received over a period of more than seven years, commencing January 1, 1979, USRA then applied discount rates in order to reduce the future liquidation proceeds to their 1976 values. Applying these discounts (16% for land and 13% for other property) reduced the net proceeds by 57%. The end result of USRA's net liquidation analysis was that the appropriate value of Penn Central's conveyed assets was $485 million.

Section 303(b)(4) of the RRRA requires that "other benefits" to the estate from the exchange are to be considered in fixing the constitutional minimum standard. The statute does not define the term "other benefits." USRA set the value of "other benefits" to the Penn Central estate at $527 million.[37] Thus, when the Valuation Case litigation began, USRA's findings in the Final System Plan, if accepted by the Special Court, would have meant that the Penn Central estate should receive no recovery in that litigation.

After the Final System Plan was published, but before the conveyance, Congress enacted the Railroad Revitalization and Regulatory Reform Act of 1976, amending the RRRA. The statute now provides for Certificates of Value, which are new securities issued by USRA and backed by the full faith and credit of the United States, as a partial guarantee of the value of the ConRail securities the estates are to receive in exchange for their properties. Moreover, the amended statute requires the Special Court to make findings as to the amount, if any, of compensable unconstitutional erosion incurred by the estates and as to the net liquidation value of the conveyed properties. Compensable unconstitutional erosion is relevant in two contexts. The Special Court must take the amount of compensable unconstitutional erosion into account in determining whether the exchange meets the constitutional minimum standard of fairness and equity, and must include that amount, if any, in computing the redemption value of the Certificates of Value. The Certificates of Value represent an obligation on the part of the United States Government to pay in cash, not later than 1987, an amount equal to the net liquidation value of the assets, less "other benefits," plus compensable unconstitutional erosion, plus interest on the sum thus calculated, at the rate of 8% compounded annually, less the aggregate of the actual value of the ConRail securities on the date of redemption and any dividends which may have been paid thereon.

The Special Court has rendered two decisions addressing the major legal issues upon which the eventual outcome of the litigation will probably depend. The first of

37. The principal components of this figure were a projected savings of $287.7 million in additional administration expenses which would have accrued between 1976 and 1978, and the sum of $203.2 million representing USRA's estimate of the deficiency between the liquidation value of the equipment conveyed to ConRail, and the outstanding debt on that equipment assumed by ConRail.

these concerns the meaning of "compensable unconstitutional erosion" *In re Valuation Proceedings under §§ 303(c) and 306 of the Regional Rail Reorganization Act of 1973*, 439 F. Supp. 1351 (Special Ct. 1977) *(Erosion Opinion)*; and the second concerns the definition of "net liquidation value" and "constitutional minimum value." *In re Valuation Proceedings Under §§ 303(c) and 306 of the Regional Rail Reorganization Act of 1973*, 445 F. Supp. 994 (Special Court, 1977) *(Valuation Opinion)*. The purpose of both opinions is to establish a framework of ground rules to guide the parties in their trial preparations, and to guide the masters who are to conduct the evidentiary hearings. For that reason, neither opinion purports to represent the final and unalterable views of the Special Court on these issues, but it would be reasonable to assume that any party seeking reconsideration would bear a significant burden of persuasion. Both decisions are, of course, subject to eventual review by the Supreme Court.

Judge Friendly's opinion for the Special Court in the *Erosion Opinion* expresses the view that "unconstitutional erosion arises only when a losing business has been required to continue to operate against its will for more than a reasonable period," and that the term "against its will" means "that some identifiable agency of government having power to do so should have thwarted its desires [to cease operations]." 439 F. Supp. 1351 at 1356.

There are two kinds of erosion to be considered. Financial erosion refers to the creation of claims against the Debtor's estate which prime the claims of pre-bankruptcy creditors, both secured and unsecured; and physical erosion refers to the reduction in value of the physical assets, depletion of cash, etc. As the Special Court noted, the transferors' erosion claims are of great magnitude. For example, the Penn Central asserts that its claim for compensable unconstitutional erosion is approximately $900 million.

The Special Court fixed the date for the commencement of potential unconstitutional erosion at February 9, 1973, the date on which the President signed the Senate Joint Resolution which revoked the Trustees' work rule changes and mandated continued operation of the railroad. That was also the date on which Congress directed the Secretary of Transportation to devise a plan for the preservation of rail service in the Northeast; the Special Court regarded this direction to the Secretary of Transportation as an event which rendered futile any later applications for abandonment authority.

Establishing the February 9, 1973 date would have validated most of Penn Central's $900 million claim for unconstitutional erosion, except for the fact that the Special Court further concluded that, because of regulatory delays, Penn Central would not actually have been able to terminate rail operations until April 1, 1976. However, the Special Court added a caveat to this latter conclusion, namely, that the Trustees were free to try to prove that they could actually have terminated rail operations over some or all of the Penn Central system earlier than April 1, 1976.

The net effect of the *Erosion Opinion*, therefore, would seem to be that, unless the Trustees can persuade the Special Court that the ICC would have approved abandonment of portions of the system earlier than April 1, 1976, or that the federal courts would not have permitted abandonment proceedings to drag on for 38 months in the circumstances then prevailing,[38] there will be no award for pre-conveyance erosion.

38. *In re Central R.R. of New Jersey*, 485 F.2d 208 (3d Cir. 1973); *In re Penn Central Transp. Co.*, 355 F. Supp. 1343 (E.D. Pa. 1973).

Be that as it may, the *Erosion Opinion* does make clear the Special Court's view that that 38-month period "cannot be taken into account a second time in determining when the proceeds of sales would come into hand." 439 F. Supp. at 1366 n.28. Thus, it would seem that, apart from any other flaws in the Master Liquidation Plan embodied in USRA's Final System Plan, a major portion of its projected "other benefits" would be eliminated, and its projected 57% net discount of the liquidation proceeds would be substantially reduced.

It now appears, however, that USRA is completely revising its Master Liquidation Plan (now designated a "retrieval model"), and is also reassessing all aspects of its real estate valuation effort and re-calculating all of its estimates of sales of scrap.[39] In short, it appears that USRA will attempt to substitute its new theory of valuation—the retrieval model—and apply to that model data other than that used in the Final System Plan. At the present time, the results of these revisions are not available, and whether they will survive the adversary proceedings before the Special Court is a matter of conjecture.

In its October 12, 1977 *Valuation Opinion,* the Special Court did not reveal its views on the "other benefits" issue. It should also be noted that USRA has apparently revised its approach to the "other benefits" issues by eliminating the 1976-1978 administration claims component but adding many other items. As noted by the Special Court, "all these claims are hotly disputed by the transferors." 445 F. Supp. at 1043.

The *Valuation Opinion* did provide some guidance to the parties on the valuation issues. The Court rejected

39. The Government, including USRA's position is contained in "Statement of Government Parties Concerning Changes in Dismantling Model Assumptions and Continuing Work Efforts." Corp. Reorg. Reporter 1675:658.

USRA's contention that net liquidation value may be determined only on the assumption that all sales would be for non-rail use, and thus enabled the transferors to show what the properties would have sold for to other railroads. On the other hand, the Court excluded from consideration hypothetical sales to, or condemnations by, the United States Government, and also ruled out several of the more generous valuation theories espoused by the transferors (reproduction cost less depreciation, social value, etc.), and essentially concluded that fair market value and net liquidation value were synonymous.

While permitting the governmental parties to continue to assert that scrap value (the so-called "trash can" theory) is equivalent to net liquidation value, the Court also had this to say:

> While the cases previously reviewed [which used valuation approaches other than market value] do not carry the weight the transferors would give them, we cannot be wholly insensitive to the views that seem to underlie them. The courts rejected market value as the measure of just compensation in circumstances which made that measure suspect.
>
> Circumstances peculiar to this case make market value particularly hard to prove. The transferors face serious difficulties in proving alternative scenario sales [sales to profitable railroads or public entities other than the United States], and the amounts that would have been obtained from those sales. These difficulties are increased by the chilling effect, not disputed by the Government, that serious discussion of the Rail Act had on the prospect of such sales. The discussion and enactment of the Act eliminated any incentive other parties might have had to negotiate purchases.

This does not mean that we should reject the role of market value in determining just compensation. Nor, however, should we bind a notion as fundamental as just compensation by the sterile logic of provable market value if a manifestly unfair result is produced. We may have such a situation here. It seems incredible that these 19,000 miles of railway and freight and passenger terminals, together with the equity in rolling stock, were worth only $685 million, the sum arrived at in the revised [Master Liquidation Plan] of March 1, 1976. It is nearly as unbelievable as the zero award in *PATH*. Of course, the revision of [Master Liquidation Plan] now in progress or attacks on it by the tarnsferors may considerably augment this figure. It may also be that the transferors will suceed in showing a higher value by proving the potential salability of some of the property for rail use. The Government parties might be well advised not to be overly finical in their attitude toward such proof.

It suffices now to note that if the transferors should not be able to establish a figure for [net liquidation value], which would square with our notions of what constitutes 'just compensation,' we may be obliged to consider some other method to arrive at [constitutional minimum value]. This would not be to deny the thesis of the Government that value to the taker should not be considered. However, if the unique circumstances of this case make it impossible to establish a market value which constitutes just compensation, it may be necessary to resort to some other rule.

. . .

If it should prove impossible to establish a market value which constitutes just compensation, the basis

that now seems to us most deserving of serious consideration—whether as the sole basis or as one to be considered along with [net liquidation value] we need not now determine—is a basis related to original cost. In contrast to most condemnations, the property is not being converted to new uses; ConRail is being substituted for the transferors. In other words, ConRail has been put in roughly the same position it would have occupied had it made the transferors' original investment when they did and depreciated it at the proper rate. Thus, a figure related to original cost may have some relevance to the value of what is being transferred. We use the phrase 'related to' since not only must allowance be made for depreciation, but a further deduction might be justified to reflect physical deterioration beyond the point provided by the normal depreciation allowances but not constituting [compensable unconstitutional erosion]. ConRail is being substituted as the operator of a deteriorated railroad. Since ConRail must pay for the deterioration when it rehabilitates the property, the Government should benefit through a deduction in its purchase price (except insofar as the deterioration constitutes [compensable unconstitutional erosion]).

At 1029.

To summarize, then, the governmental parties can take heart from the scrap value possibility and the exclusion of reproduction cost and social values, as well as from the exclusion of hypothetical sales to the Government as influencing fair market value; and the transferors can derive encouragement from the Court's apparent skepticism toward USRA's valuation figures, and from the references to depreciated original cost as a measure of value.

2. Relationship of the Valuation Case to the Plan Distributions

The ultimate outcome of the Valuation Case litigation will be based upon an objective application of legal and constitutional principles, without regard to the question of how various classes of creditors of Penn Central would be affected by a greater or lesser recovery.[40] Any discussion of the potential impact of various possible levels of recovery in the Valuation Case upon the likelihood of redemption of the various securities to be issued under the Plan involves a risk that it will be misunderstood as indicating what a satisfactory conclusion of the Valuation Case litigation would be. That is not my function, and it certainly is not my intention. But I believe that at least a general understanding of the relationship between the Valuation Case litigation and the Plan distributions is necessary to an evaluation of the fairness and equity of the proposed distributions in order to ascertain whether the Plan does or does not fairly allocate the risks and potential benefits that the Valuation Case entails.

The Plan contemplates that a substantial portion of the securities to be issued will be redeemed between consummation date and 1987, primarily from the proceeds of the Asset Disposition Program. The outcome of the Valuation Case will have no bearing upon those redemptions,

40. In its *Valuation Opinion*, the Special Court urged the parties to explore the possibilities of amicable settlement of the entire controversy. Presumably, any such settlement would also be in conformity with legal and constitutional principles, or at least within the reasonably foreseeable range of results which would be obtained from litigating those legal and constitutional issues. No doubt the impact upon various classes of creditors would be a factor in any such negotiations. For purposes of this Opinion, it is plainly necessary to proceed on the assumption that the Valuation Case will not be settled; but this should not, of course, be regarded as an expression of disagreement with the Special Court's suggestion.

and it is therefore appropriate for present purposes to consider only the securities which will remain outstanding in 1987. It is reasonable to suppose that by 1987, the principal amount of debt-type securities still outstanding will be approximately $1.487 billion, and that accrued but unpaid interest on those securities which are interest-bearing will aggregate approximately $481.3 million, for a total of $1.969 billion. Unless the net recovery from the Valuation Case is sufficient to pay off those securities, the Valuation Case will contribute nothing to the value of the common stock of the reorganized company. This does not mean that the common stock would have no value, but merely that its value would be dependent primarily upon the fortunes of Pennco.

At the risk of belaboring the obvious, it should also be pointed out that 90% of the common stock of the reorganized company is used to pay the claims of Penn Central's creditors; that is, a Valuation Case recovery sufficient to redeem the $1.969 billion in debt-type securities of the reorganized company would not translate into payment in full of Penn Central's creditors.

What level of Valuation Case recovery would be sufficient to provide for the redemption of that amount of debt-type securities by 1987? In attempting to answer that question, several factors must be kept in mind. The Certificates of Value, which will be the primary source of the cash to redeem these securities, bear interest at the rate of 8% compounded annually, from and after April 1, 1976. The base amount of the CVs (*i.e.*, the 1976 amount upon which interest is to be calculated) is geared to the outcome of the Valuation Case. While the base amount of the Certificates of Value therefore cannot be determined until the Valuation Case litigation is concluded, if that litigation terminates before 1987, USRA

would have the right to pay off on the Certificates of Value before 1987.[41]

The Series B notes and Series C notes accrue interest, the Series D term notes and A and B bonds will not accrue interest if paid currently, preference stock and CBIs are non-interest-bearing. The rates of interest on some securities which accrue interest differ from the interest rate specified for the Certificates of Value. For that reason, payment of the Certificates of Value before 1987 would not have precisely the same consequences as would payment in 1987. By the same token, 1976 base values of the Certificates of Value would not translate into as large an amount of cash if the CVs are paid off earlier.

Subject to the foregoing variables, and assuming the cash forecast is accurate, it can be stated that a net recovery from the Valuation Case (*i.e.*, 1976 base value of the Certificates of Value) in the amount of approximately $797 million, with interest thereon compounded annually at the rate of 8%, should produce enough money to redeem the remaining Series B notes, Series C notes, Series D notes, B bonds, preference stock and Certificates of Beneficial Interest (CBI), if the Certificates of Value are paid in 1987.

In view of the nature of some of the objections originally pressed, for example, by state and local tax claim-

41. As explained in the preceding section of this Opinion, the Certificates of Value amount to a Government guarantee that the Valuation Case award will be paid in cash if the value of ConRail securities issued to the transferors is insufficient to pay the award. In order not to complicate the analysis unduly, this Court (like the parties to this proceeding) has assumed that the ConRail securities will be valueless. If that assumption proves incorrect, the net result should nevertheless be the same. There is, however, at least a theoretical potential risk that if the value of the ConRail securities is disputed, the arbitrators who will resolve the dispute may make an erroneous determination. It is necessary and, in my judgment, not unsettling, to disregard that risk.

ants, it may be helpful to illustrate how Valuation Case recoveries at lower levels would affect redemption of the various classes of securities:

	(in Millions) *Amount Outstanding As of 12/13/87*			
	Prin.	*Int.*	*Total*	*Range of Base Values as of 4/1/76*
Series B notes	$249.8	$329.2	$579	0 -234.4
Series C1 notes		152.1	152.1	234.5-296
....	131.2		131.2	296 -349
Series D	121.6	(2)	121.6	349 -398.3
B Bonds(1)	204.6	(2)	204.6	398.4-481.1
Preference Stock	567.3	(3)	567.3	481.2-710.8
CBI	213.2	(3)	213.2	710.9-797.1(4)

(1) Includes $6.6 million in accrued interest.

(2) Interest paid currently.

(3) Non-interest-bearing.

(4) By Order No. 2922, this Court authorized the Trustees to offer taxing authorities a cash payment settlement equal to the larger of 50% of the principal of their post-petition claims or 44% of the principal of their pre- and post-petition claims. To the extent this offer is accepted, there will be a reduction in the amount of C1 and D notes issued under the Plan. If all tax authorities accepted the offer, a base value of $633.2 million would satisfy the CBI. The figures incorporated in the above table assumes $25 million will be paid out under the cash settlement option.

It is difficult to quantify the impact of recoveries above the $797.1 million (1976 base value) level upon the value of the common stock of the reorganized company. The excess over what would be required to redeem the debt securities listed above would belong to the reorganized company and should have the effect of improving the quality of its securities, including common stock; but it would be somewhat misleading to suggest that any such recovery would increase the market value of the common stock dollar-for-dollar, or that it would necessarily be paid to the shareholders in dividends. About all that can be said on the subject at this juncture is that modest amounts

recovered in excess of the amount needed to redeem the debt securities would presumably have little effect upon the value of the common stock; that recoveries at substantially higher levels would significantly enhance the value of the common stock;[42] and that the "reasonable range of litigation possibilities" in the Valuation Case is broad enough to encompass either eventuality.

F. State and Local Tax Claims

1. *Description of Claims*

Claims for unpaid taxes, asserted by various state and local taxing entities, total approximately $523 million, including interest to December 31, 1977. Approximately $73.3 million of this amount represents taxes which accrued before the bankruptcy petition was filed; the balance of $449.7 million represents unpaid taxes which accrued during reorganization, June 21, 1970 through December 31, 1976. All taxes accruing after January 1, 1977 are being paid on a current basis. Of the $523 million total, approximately $300 million is attributable to properties which were conveyed to ConRail free and clear of all liens and encumbrances; the balance of $223 million represents taxes assessed against retained assets. (In discussing the securities distributed to tax claimants, Section II-B, the total claim there referred to of $451.5 million was net of claims satisfied under the Alternative Settlement Program.)

These taxes are imposed under the local laws of the 17 American jurisdictions in which the Debtor conducted

42. It must be remembered, however, that, since we are talking about common stock, any enhancement in value by virtue of 1987 payments must be discounted back to the consummation date, for purposes of comparing the dollar amounts of the claims of Penn Central's creditors with the actual dollar values of the distributions they will receive under the Plan.

rail operations. These laws vary greatly, and there are corresponding variations in the precise characteristics of various tax claims. The totals set forth above include general corporate taxes and similar levies, as well as real estate taxes. Real estate taxes may be levied on a parcel-by-parcel basis, countywide, or even statewide. In some jurisdictions, they represent a general *in personam* claim against the Debtor, as well as a charge against specific property, whereas in other jurisdictions they are solely *in rem*. Some jurisdictions exempt transportation property, others do not. There may also be procedural differences affecting such matters as whether or not a particular tax lien has been perfected.

For purposes of discussion, all of these variations may be ignored. It will be assumed that all claims for taxes related to the pre-bankruptcy period constitute valid liens against all of the physical assets of the Debtor, and that this lien is superior to the claims of general creditors, and at least arguably superior to the claims of all other pre-bankruptcy lien-holders except the Federal Government.

The post-bankruptcy taxes, on the other hand, are claims of administration. As such, they have priority over all pre-bankruptcy claims. The very existence of unpaid administrative claims of this magnitude ($449.7 million in unpaid taxes, plus about $350 million in unpaid operating expenses, represented by the Government's § 211(h) claims) is striking proof of the uniqueness of this reorganization, and of the corresponding novelty of the problems involved.

In ordinary corporate reorganizations, the continued operation of the Debtor while reorganization planning is taking place is conducted primarily for the benefit of its creditors. Any debtor which cannot even meet its current operating expenses while being temporarily relieved of the burden of pre-bankruptcy debt is not likely to re-

main in reorganization very long; it will be liquidated. Hence, the possibility of any significant amount of post-petition taxes remaining unpaid does not ordinarily arise.

Railroad reorganizations differ from ordinary corporate reorganizations because of the public interest in continued rail service. Bankruptcy liquidation is not available to railroads. A railroad debtor simply must continue to operate, without regard to the interests or desires of its creditors, at least until such time as the constitutional rights of secured creditors under the *Brooks-Scanlon* line of cases are clearly in jeopardy. Here again, however, inability to generate sufficient revenue to pay taxes accelerates the triggering of *Brooks-Scanlon* rights.[43]

With the enactment of the RRRA and the decision of the Supreme Court in the *Regional Rail Reorganization Act Cases,* 419 U.S. 102, 95 S. Ct. 335, 42 L. Ed.2d 320 (1974), it was made clear that, in the case of the Northeastern railroads, including Penn Central, *Brooks-Scanlon* rights could be violated in the short run, so long as ultimate vindication of constitutional rights was assured.

The period of time covered by the post-bankruptcy taxes in this case extends from June 21, 1970 to December 31, 1976. During the first part of this period, from the filing of the bankruptcy petition until early 1973, the Trustees were attempting a private sector reorganization. This was based upon the assumption that substantial changes in the regulatory and labor relations climate, which the appropriate governmental authorities were being urged to

43. The term "*Brooks-Scanlon* rights" is intended to describe the constitutional right of the owners (and creditors) of a railroad not to be deprived of their property for public use without just compensation; protection against violation of that right would include termination of loss operations in the absence of adequate subsidy, and the eventual right to dispose of the property or use it for other purposes. *See Brooks-Scanlon Co. v. Railroad Comm'n,* 251 U.S. 396, 40 S. Ct. 183, 64 L. Ed. 323 (1920).

effectuate, would take place within a reasonable time. During the second part of the period, from the Spring of 1973 until the end of that year, Congress was addressing itself to a possible legislative solution. The third phase covers the period required for implementation of the RRRA.

There was never any cash available for the payment of taxes during any of these phases. Operations until 1973 were made possible only because the Government guaranteed the Trustees' borrowings under trustees certificates, in the sum of $100 million. During the third phase, there would not have been even enough cash to meet payroll, if the Federal Government had not provided cash grants and loans to keep the railroad going. Unfortunately for the tax claimants, however, Congress did not see fit to provide cash for the payment of taxes; moreover, Congress insisted that the funds advanced (the Government's § 211(h) claim) would have the highest possible priority, both in lien and in payment, and would thus have priority over claims for post-petition taxes.

The impact of these developments upon the status of the claims for state and local taxes, and upon the relationship between those claims and the claims of other creditors, cannot be overemphasized. Because continuation of loss operations was mandated, the amount of unpaid tax claims and other unpaid administration claims was greatly increased, probably by more than half a billion dollars in the aggregate. At the same time, the rights which such claims would have on liquidation (which is the standard for assigning "value" to all claims in the present context) were significantly altered; moreover, the nature and extent of this alteration could well provide the grist for many years of litigation.

While the hypothetical liquidation rights of tax claimants in the absence of the RRRA are of only academic

interest, a brief review of that scenario provides a useful contrast. Presumably, any such wholesale liquidation of the Debtor's assets for the purpose of paying off its creditors would have been conducted on an orderly basis, under Court supervision, and thus would not have produced immediate cash payments for all. Nevertheless, it is reasonable to assume that, disregarding possible challenges to the amount and validity of particular tax claims, all tax claims would have been satisfied within a reasonable time, either by cash payments from sales of assets, or by acquisition of liened parcels through tax sale proceedings. The probability that in many instances mortgagees or other junior lienholders would pay or compromise tax claims to protect their own liquidation rights should not be overlooked.

The liquidation rights of the tax claimants in the present circumstances are quite different. In the first place, the properties against which roughly three-fifths of the tax claims are assessed have been conveyed to ConRail free and clear of all liens, including tax claims. With respect to pre-petition taxes, this means that the liens are transferred to the proceeds to be derived from the Valuation Case; but realization from that source is deferred and uncertain. With respect to post-petition taxes, the problem is one of the proper allocation of administration expenses. That is, it cannot be assumed that post-petition taxes, even though they are administration claims, would be satisfied promptly by retained assets, in the event of liquidation. Assuming the validity of the Government's super-priority, the tax claims would not have access to cash or other liquid assets, and could not be satisfied from sales of retained assets without doing violence to mortgage liens upon retained assets. The notion that tax claims generated by conveyed assets would automatically be transferred to, and prime existing mortgages on, retained assets is one which would not likely be accepted by mortgagees without a struggle.

The mortgagees would have substantial arguments to present. Implementation of the Rail Act has made this proceeding more nearly like a standard Chapter X proceeding than it was before; and under Chapter X, the rights of secured creditors cannot be altered without their consent. Moreover, equitable principles would be applicable, even on liquidation; and pro rata allocation of administration expenses is equitable.

A second set of problems stemming from implementation of the RRRA has to do with ascertaining the appropriate amounts of tax claims. The values assigned to the conveyed properties in the Final System Plan (FSP) are only about 50% of the assessments upon which the tax claims are based. While no one takes these FSP valuations at face value, and indeed they have been referred to by the Special Court in its most recent Opinion as seemingly "incredible." *See In re Valuation Proceedings under §§ 303(c) and 306 of the Regional Rail Reorganization Act of 1973*, Misc. No. 76-1, 445 F. Supp. 994 at 1029 (Special Ct., Oct. 12, 1977), a persuasive argument can be made that, at the very least, final determination of the proper amounts of tax claims against conveyed property should await resolution of the valuation issues by the Special Court. Section 64(a)(4) of the Bankruptcy Act provides, in straight bankruptcy proceedings,

> that no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court.

While not directly applicable in railroad reorganizations under § 77 or to ordinary reorganization under Chapter

X, it does provide guidelines which the reorganization court may look to in exercising its equitable authority. Section 2(a)(2A) of the Bankruptcy Act gives the reorganization court jurisdiction to "hear and determine . . . any question arising as to the amount or legality of any unpaid tax . . ."; this statute has been interpreted as conveying broad authority over tax assessments. *See Amarillo v. Eakens,* 399 F.2d 541 (5th Cir. 1968), *cert. denied,* 393 U.S. 1051, 89 S. Ct. 688, 21 L. Ed.2d 692 (1969).

A third problem area has to do with the direct impact of the RRRA implementation upon the nature of the administration claim represented by state and local taxes. It can be argued that, in prescribing the § 211(h) program, Congress effectively brought about a de facto classification of administration claims, by providing interim financing for claims which were required to be paid if rail operations were to continue, on the one hand, and failing to provide such financing for administration claims, such as taxes, non-payment of which would not result in cessation of rail service.[44]

In short, by (a) mandating continuance of loss operations until April 1, 1976, (b) providing cash loans and grants in the amounts necessary to prevent shutdown, but not for the payment of taxes, and (c) providing superpriority for the claims of the Federal Government, Congress seems to have gone a long way toward neutralizing the administration claim status of the post-petition tax claims, rendering them, at least arguably, not very different from claims for pre-bankruptcy taxes.

A final problem area attributable to implementation of the RRRA is less serious, but nevertheless significant

44. That Congress was aware of this problem cannot be doubted. The statute was amended in 1976 to mandate the "pass through" of taxes paid by tenants. 45 U.S.C. § 794. *See In re Penn Central Transp. Co.,* 402 F. Supp. 106 (E.D. Pa. 1975), *aff'd,* 538 F.2d 320 (3d Cir. 1976).

enough to require brief mention. The arduous task of drafting the more than 2,000 conveyancing documents has not yet been completed; indeed, only a few of such documents have yet been recorded. The Court is advised that the entire process will not be completed for several months. Apparently, there will be a separate deed for each county, with separate attachments containing detailed descriptions of what is included in, and what is expected from, the conveyance. The task of actually collecting tax claims through foreclosure proceedings, in the event of liquidation, would no doubt be rendered more difficult and complicated by virtue of the need to reconcile these conveyancing documents with tax parcel records in order to obtain accurate information about the property remaining available for tax sale.

2. *Treatment of State and Local Tax Claims Under the Plan*

The Plan treats all state and local tax claims alike, without distinction between pre- and post-bankruptcy status. The amount of each claim includes the principal claim plus interest to December 31, 1977, exclusive of penalties. Of this amount, 44% would be paid in cash (26.4% on consummation date, 8.8% on December 31, 1978, and 8.8% on December 31, 1979). The deferred portion of these cash payments (*i.e.,* 17.6%) would bear interest at the rate of 7% per annum, from the consummation date, and would be evidenced by Series D serial notes bearing appropriate maturities.

The remaining 56% of each claim would be satisfied with Series C-1 notes or Series D term notes, depending upon whether the claim relates to conveyed or retained assets. For purposes of this allocation, all general corporate and similar tax claims would be treated as claims

against retained assets; only real estate taxes would be assigned to the "conveyed asset" category.

The Series D term notes are general obligations of the reorganized company, and bear interest at the rate of 7% per annum payable semi-annually. They are secured obligations, having a lien on substantially all of the assets of the reorganized company. With respect to retained assets, their position is second only to the claims of the Federal Government; with respect to the Valuation Case proceeds, their position is junior only to the claims of the Federal Government, and the Series C notes. Like all of the other secured notes, the Series D notes may be redeemed at any time. If not sooner paid, the Series D term notes originally issued will mature not later than December 31, 1987, but that maturity date may be extended up to five years if the Valuation Case proceeds prove insufficient to pay them off in full. Under certain circumstances, Series C-1 notes may later be converted into Series D term notes; any Series D term notes later issued for that purpose will mature with the original D notes.

The deferred portion (56%) of tax claims attributable to conveyed assets would be satisfied by the issuance of Series C-1 notes. These are not general obligations of the reorganized company, but have the first claim, after the Federal Government claim, to the proceeds of the Valuation Case. Series C notes bear interest at the rate of 8%, compounded annually. The proceeds of the Valuation Case would be credited first to interest, then to principal. At the conclusion of the Valuation Case, the principal amount (but not interest) of any unpaid Series C-1 notes would automatically be converted into Series D term notes, described above, unless some of the Series B notes (representing claims of the Federal Government) remained unpaid, in which case, that amount would be converted into Series E notes. Series E notes would be

general obligations of the reorganized company, but would not bear interest. They would mature December 31, 1993, or six years after conclusion of the Valuation Case, whichever was later; and this maturity might be extended for an additional 10 years. In any year in which the consolidated net earnings of the reorganized company exceeded $50 million, the company would be required to redeem up to $30 million in Series E notes. On liquidation, Series E notes would be junior to all other debt obligations.

These complex provisions are designed to ensure that the balance of all taxes attributable to retained assets will be paid fairly promptly from the Asset Disposition Program if possible, from the Valuation Case if necessary, and, as to both principal and interest, by the reorganized company in any event; and that the balance of taxes attributable to conveyed property will be paid from the Valuation Case, that interest to the end of the Valuation Case will be paid first, and that any remaining principal will be paid by the reorganized company, and that interest will be paid also, unless the outcome of the Valuation Case is disastrous.

3. *The Alternative Settlement Program*

Independently of the Plan of Reorganization, pursuant to arrangements between the Federal Government and the Trustees, which were approved by this Court in Orders Nos. 2922 and 2929, any taxing entity which wishes to do so is at liberty to accept, in full settlement of its tax claims, either 44% of the principal amount of all taxes, or 50% of post-bankruptcy taxes, whichever is greater. Moreover, under this program individual tax claims aggregating less than $10,000 (or which the claimant is willing to compromise for $10,000) would be paid in full. Claimants accepting the compromise would not, of course, share in the distributions under the Plan; but, on the other hand,

they would be paid immediately, without regard to the final outcome of the Plan proceedings.

4. Objections to the Plan by State and Local Tax Claimants

As originally proposed, the Plan accorded less favorable treatment to tax claimants than does the Plan now before the Court. A great many objections were filed on behalf of taxing entities, and these objections were extensively briefed and argued. Thereafter, the Trustees modified the Plan, so that it now stands as outlined above. At the hearing on this modified Plan, most of the objecting tax claimants withdrew their objections, and now support the Plan. A few tax claimants, most notably the State of New York and the City of Jersey City, continue to press the objections initially asserted by themselves or others; and it is reasonable to suppose that other tax claimants, who did not particpate in either hearing, may still be dissatisfied with the Plan. It is therefore necessary to deal with all of the objections which have been expressed, at least to the extent that they have not plainly been rendered moot by the changes in the Plan.

a. Exclusion of Penalties

A few of the taxing entities originally asserted that their claims should include not only principal and interest, but also statutory penalties. It is not clear that this objection is being pressed by any of the present objectors. In any event, it is without merit.

The lack of merit in this contention is clearest with respect to pre-bankruptcy taxes. Section 57(j) of the Bankruptcy Act expressly provides

> debts owing . . . to any state or any subdivision thereof as a penalty or forfeiture shall not be allowed.

This section is applicable to reorganizations under § 77. *In re Tennessee Central Ry.*, 316 F. Supp. 1103, 1116 (M.D. Tenn. 1970), *vacated*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893, 93 S. Ct. 119, 34 L. Ed. 2d 150 (1972); and *see In re N.Y., N.H. & H. R.R.*, 304 F. Supp. 1121, 1135 (D. Conn. 1969).

I am satisfied that the same result is applicable to post-reorganization taxes as well. The purpose of penalties is punitive. *United States v. Childs*, 266 U.S. 304, 307 (1924). In deferring the payment of state and local taxes during reorganization in the present case, the Trustees were acting pursuant to an express Order of this Court, duly affirmed on appeal. *In re Penn Central Transp. Co.*, 325 F. Supp. 294 (E.D. Pa. 1970), *aff'd*, 452 F.2d 1107 (3d Cir. 1971), *cert. denied*, 406 U.S. 944, 92 S. Ct. 2040, 32 L. Ed. 2d 331 (1972). To hold that the estate should be punished for continuing to provide rail service despite its lack of funds, and for complying with an Order of this Court, would be the height of injustice.

Penalties may be imposed for blameworthy failures to comply with legal requirements which impose no insurmountable burden upon the estate. In the case of *Boteler v. Ingels*, 308 U.S. 57, 60 S. Ct. 29, 84 L. Ed. 78 (1939), a trustee who willfully failed to pay a motor vehicle license tax was held properly subject to a penalty. And in *Nicholas v. United States*, 384 U.S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853 (1966), a penalty was upheld for a trustee's failure to file required federal tax returns. But I have not been made aware of any case in which the imposition of penalties was upheld in circumstances remotely resembling the present case.

It is argued that the Act of June 18, 1934, 28 U.S.C. § 960, mandates a different conclusion. It provides:

> Any officers and agents conducting any business under authority of a United States court shall be sub-

> ject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

This statute, which was intended to lay to rest the notion that court-appointed trustees and receivers were exempt from taxes, simply does not address the question of the collectability of post-bankruptcy penalties.

In my view, recognition of the full amount of state and local tax claims, plus interest, but excluding penalties, reflects the balance between federal and state interests which Congress, in the exercise of its bankruptcy and commerce powers, intended to strike.

b. Payment in Full in Cash

Section 77(e) of the Bankruptcy Act, provides that a plan may be approved if, *inter alia,*

> (3) the plan provides for the payment of all costs of administration and all other allowances made or to be made by the judge, except that allowances provided for in section (c) paragraph (12) of this section may be paid in securities provided for in the plan if those entitled thereto will accept such payment, and the judge is hereby given power to approve the same.

The objectors argue that post-bankruptcy taxes are "costs of administration," and that the Plan cannot be approved unless it provides for their payment in cash. In my view, however, the quoted language does not mean that every item of operating expenses incurred in conducting business operations during bankruptcy is a "cost of administration." That section deals with "costs of administration and *all other allowances made or to be made by the judge.*" Applying the familiar *ejusdem generis* maxim, I believe that the quoted language refers only to the costs incurred

in the reorganization process itself, which must be allowed by the judge, and not with the ordinary business expenses of the Debtor.

In equity receiverships, which preceded § 77, taxes were regarded as an expense of operation, to be paid with other expenses, *Michigan v. Michigan Trust Co.,* 286 U.S. 334, 52 S. Ct. 512, 76 L. Ed. 1136 (1932); *Southern Ry. v. United States,* 306 F.2d 119, 127 (5th Cir. 1962), but after receivers' expenses, *id.; 2 Clark on Receivers* § 627, at 1052-53 (3d ed. 1939).

The Supreme Court has held that there must be flexibility in the manner in which tax claims are satisfied. *See, e.g., Gardner v. New Jersey,* 329 U.S. 565, 574, 67 S. Ct. 467, 91 L. Ed. 504 (1947). In the *New Haven* reorganization, a plan was approved which did not provide for the payment of post-petition taxes in cash. *In re N.Y., N.H. & H. R.R.,* 304 F. Supp. 1121, 1134 (D. Conn. 1969).

I recognize that my colleague, Chief Judge Whipple in *In re Central R.R. of N.J.,* 425 F. Supp. 1055 (D. N.J. 1977), *appeal docketed,* No. 77-1960 (3d Cir., July 25, 1977) (*CNJ* case) has expressed the view that post-petition taxes must be paid in cash in full. Because of the peculiar features of the "plan" under consideration in that case (administration claims were to be paid in ConRail stock, while the accompanying Certificates of Value and all other assets of the estate would have gone to junior creditors), it is doubtful that the New Jersey court intended its "cash only" holding to be absolute and universal, or that it fully considered all of the possible ramifications of such a sweeping declaration.

Section 77B(b)(3), the predecessor of Chapter X, formerly required that costs of administration be paid "in cash." Chapter X requires merely that "costs and expenses of administration" be paid. Even under § 77(b)

(3), however, the cash requirement was not regarded as an absolute. Thus, in *In re Parker-Young Co.*, 15 F. Supp. 965 (D. N.H. 1936), it was held that, so long as there was assurance of eventual payment, securities could be used. In *In re Janson Steel & Iron Co.*, 47 F. Supp. 652 (E.D. Pa. 1942), a plan was approved which contemplated payment of administration expenses, including taxes, 10% in cash, and 60% within five years. The case of *In re New Era Housing Corp.*, 117 F.2d 569 (3d Cir. 1941), relied upon in the *CNJ* case, did not require that administration claims be paid in cash. The court merely held

> that such allowances as are made in a 77B proceeding must be paid at the time of reorganization either in cash or by the delivery of securities which themselves evidence an indebtedness or obligation of or interest in the reorganized company.

117 F.2d at 572. Under present Chapter X, of course, the "in cash" requirement has been eliminated.

I am satisfied that approval of this Plan need not be withheld merely because it does not provide for payment of state and local tax claims in cash, or provide for full payment immediately. I therefore proceed to consider whether the Plan should be approved as fair and equitable in its treatment of these tax claims.

5. Fairness to Tax Claimants

As noted earlier in this Opinion (II-B-1 *supra*), reorganization of the Debtor has obvious advantages over liquidation in that, by reason of the growth potential of Pennco and other circumstances, reorganization will undoubtedly produce a greater total of values for distribution than would liquidation. That conclusion is of less importance to senior creditors (such as the tax claimants) who are to receive debt securities, than it is to creditors

scheduled to receive some equity participation, or to junior creditors whose claims might be lost altogether in a liquidation proceeding. But the tax claimants, too, have an interest in the continuation of the business enterprises constituting the Debtor's estate.

To the extent that tax claims can properly be relegated to the proceeds of the Valuation Case (and this is clearly true with respect to taxes in jurisdictions where only an *in rem* remedy is available, with respect to about $42 million of pre-reorganization taxes, and, as discussed above, quite possibly true with respect to three-fifths of the post-petition taxes) tax claimants have a vital stake in the continuation of the business enterprise consisting of the conduct of the Valuation Case litigation. This is not just the low-threshold interest in seeing to it that the recovery is adequate to pay off tax claims, but also to make sure that the results of the valuation process do not provide reasons for challenge to the underlying tax assessments. In a more general sense, the taxing entities have an interest in avoiding the economic upheavals which would accompany liquidation of so vast an enterprise, and in the preservation of rateables. While these factors are not susceptible to precise measurement, and are much less pronounced now that possible cessation of rail services has been removed from the equation, these intangible benefits of reorganization as opposed to liquidation are nevertheless real.

In short, it would be inaccurate to characterize this as a situation in which tax claims are being deferred in order to produce a reorganization which will only benefit others.

Nevertheless, this Plan cannot be approved by the Court if the proposed treatment of tax claims in relation to other claims does not accurately reflect their relative priority. This requires an analysis of how tax claims would

fare on liquidation, compared to other claims. As discussed above in Subsection 1, Description of Tax Claims, this analysis is complicated—perhaps obfuscated would be a better word—by reason of the interposition of the RRRA.

Unless the tax claimants could succeed in challenging the super-priority asserted by the Federal Government, they could not expect to have access to the cash or other liquid assets of the Debtor's estate. No basis for such a challenge has been suggested, except on constitutional grounds. Granted that such a constitutional attack might have merit (although other creditors would undoubtedly assert that they have stronger constitutional arguments than do the tax claimants), the tax claimants could hardly anticipate a prompt victory. It is apparent, therefore, that the tax claimants are primary beneficiaries of the Government compromise embodied in the Plan. In essence, 44% of their total claims will be accorded better treatment than the higher-ranking claims of the Federal Government.

I am also satisfied that the Plan treats tax claims fairly in comparison to the treatment of the claims of pre-bankruptcy secured creditors. It must be remembered that the absolute priority rule does not require sequential distributions (*i.e.*, cash payment in full to senior creditors before any distribution is made to junior creditors), but merely that the values represented by the higher-ranking claims are fully satisfied by the values distributed under the Plan. Those related sets of values are properly reflected in this Plan. The tax claimants receive a much greater percentage in cash and receive all debt securities, with no equity participation. Unlike the secured creditors (Class J), the tax claimants are virtually insulated from entrepreneurial risks.

Because of the undesirability of now predicting what the Valuation Case will produce, the Trustees have presented a Plan which would "fly" even if there should be no recovery at all in the Valuation Case. By virtue of the recent modifications to the Plan, tax claims are, for the most part, protected against even that dire eventuality. It is possible to conjure up a series of catastrophes which would jeopardize payment of a portion of the principal of the tax claims against conveyed assets (disregard of constitutional limitations by the courts, resulting in a near-zero recovery in the Valuation Case, coupled with bankruptcy of the reorganized company after piling up huge amounts of new debt), but assessments of the fairness of reorganization plans must be based upon real-world assumptions. It is virtually certain that all tax claims will be paid in full by the end of the Valuation Case.

In considering the relative treatment of tax claims and the claims of Class J creditors, it must be emphasized that the compromise with the Government, which makes possible the payment in cash of 44% of all tax claims at or shortly after consummation, is itself dependent upon concessions made by Class J creditors with respect to the Pennco pledge and the uses of Pennco income. It must also be remembered that the Plan removes all questions concerning the amount, validity, and collectability of all tax claims, a not insignificant concession. And the tax claimants, like other parties to the reorganization proceeding, would be relieved of the burdens of protracted litigation of a multiplicity of issues.

To summarize, I have concluded that the proposed treatment of tax claims is fair and equitable.

6. *Objections of Taxing Entities in the State of Ohio*

Representatives of taxing entities in the State of Ohio, while they now strongly support the Plan, have again

raised the contention that Order No. 3012, which requires current payment of all taxes accruing after January 1, 1977, should be broadened to require the Trustees to pay Ohio taxes for the year 1976. This contention is relevant to the Plan proceedings only insofar as granting the request would remove 1976 taxes from Plan treatment, and have them paid on a current basis in cash. These contentions were previously rejected. Order No. 3012 was affirmed on appeal, *In re Penn Central Transp. Co.*, No. 77-2063, 573 F.2d 1302 (3d Cir., filed Mar. 1, 1978). Moreover, it is appropriate to point out that the problem arises because of the manner in which Ohio taxes are levied and billed. Although this peculiarity somewhat defers, for Ohio taxing entities, the benefits of the Order No. 3012 payment program, the Plan's treatment of pre-bankruptcy taxes in precisely the same fashion as post-bankruptcy taxes confers a somewhat greater benefit upon Ohio taxing entities than those in other states. On balance, I believe the Ohio districts are being fairly treated.

G. Class J—Secured Creditors

1. *The Distribution to Class J Creditors*

Pre-bankruptcy secured creditors are classified in Class J. Included within this class are the holders of bonds issued under the various mortgages of Penn Central and the Secondary Debtors, certain public shareholders of the Secondary Debtors, the New Haven Trustee, and the secured bank group (whose claims are secured by a pledge of the Pennco stock).[45] Excluding claims held by Penn Central and its subsidiaries, the claims of secured creditors of Class J aggregate $1,910,729.00. Of this amount,

45. SEC Report, Table VI-A, at p. 33.

$1,418,733,000 is attributable to the Penn Central system, and $491,996,000 is attributable to the Secondary Debtors.

In a conventional, going-concern, reorganization a first step is to determine the extent to which creditors claiming secured status are in fact secured. That portion of the claim which is in excess of the value of the assets securing the claim is then treated as unsecured for the purposes of the Plan. Because the Penn Central estate has been partitioned into "conveyed" and "retained" assets, and because the value of the conveyed assets (in the sense of the benefits they will provide to the reorganized company), cannot now be determined, the conventional analysis cannot be fully carried out in this case.[46] Instead, the Plan treats all secured creditors as fully secured, both as to principal and accrued interest. But because the value of the retained assets (*i.e.*, what they can be expected to contribute to the reorganized company, and when this contribution will be realized) can now be determined, claims secured by retained assets receive somewhat different treatment in the Plan than do claims secured by conveyed assets. In short, all secured creditors are treated as fully secured, but the distributions under the Plan vary in ways intended to reflect the differences in the nature of the assets securing the claims.

With few exceptions, Class J claimants receive what is referred to as a 10-triple-30 security package: 10% of the total claim in cash; 30% in preference stock; 30% in common stock; and the remaining 30% in general mortgage bonds allocated between A and B bonds according to the proportion in which the claim is secured by retained assets. For example, if a mortgage is 60%-secured by retained assets, the distribution per $1,000 of claim would be as follows: $100 in cash, $180 in A bonds, $120 in B bonds,

46. *See* Section II-B *supra*.

TABLE I-A
DISTRIBUTION TO CLASS J CREDITORS UNDER APPROVED PLAN
(Dollars in Thousands)

Mortgage #	Issue	Rate	Year of Maturity	Claim: Principal	Claim: Interest	Claim: Total	Percent Secured by Retained Assets	Distribution: Cash	Series A Bonds	Series B Bonds	Preference Stock	New Common Stock
	Penn Central Transportation Company											
027	Boston & Albany Imp.	4¼%	1978	$ 2,720	$ 1,232	$ 3,952	100.0%	$ 395	$ 1,185	—	$ 1,186	$ 1,186
001	Carthage & Adirondack 1st	4%	1981	799	255	1,054	28.2	105	90	$ 227	316	316
053	Kanawha & Michigan 1st	4%	1990	1,539	479	2,018	100.0	202	606	—	605	605
008	Lake Shore & Michigan So. Gold	3½%	1997	43,357	11,536	54,893	58.3	5,489	9,601	6,867	16,468	16,468
011	Mohawk & Malone 1st	4%	1991	1,489	478	1,967	100.0	197	590	—	590(4)	590
012	Mohawk & Malone Consolidated	3½%	2002	2,794	777	3,571	87.2	357	935	137	1,071	1,071
065	New Jersey Junction 1st	4%	1986	1,178	373	1,551	8.4	155	40	426	465	465
017	New York & Putnam 1st	4%	1993	1,574	498	2,072	11.3	207	70	551	622	622
014	N.Y.C. & Hudson River Consolidation											
	Series A	4%	1998	62,785	20,022	82,807	100.0	8,281	24,842	—	24,842	24,842
	Lake Shore Collateral	3½%	1998	15,505	4,310	19,815	100.0	1,981	5,944	—	5,945	5,945
	Michigan Central Collateral	3½%	1998	17,101	4,755	21,856	100.0	2,186	6,556	—	6,557	6,557
013	N.Y.C. & Hudson River—Gold	3½%	1997	75,762	21,243	97,005	100.0	9,701	29,100	—	29,102(4)	29,102
015	N.Y.C. & Hudson River—R&I											
	Series A	4½%	2013	92,658	32,693	125,351	31.9	12,535	11,996	25,610	37,605	37,605
	Series C	5%	2013	63,966	25,153	89,119	31.9	8,912	8,528	18,207	26,736	26,736
301	N.Y., N.H., & Hartford HR Div. 1st	4¼%	1973	8,014(1)	3,506	11,520	90.2	1,152	3,117	339	3,456	3,456
211	P.R.R. General											
	Series D	4¼%	1981	43,641	14,451	58,092	43.2	5,809	7,528	9,899	17,428	17,428
	Series E	4¼%	1984	36,143	12,317	48,460	43.2	4,846	6,280	8,258	14,538	14,538
	Series F	3⅛%	1985	43,029	10,764	53,793	43.2	5,379	6,972	9,166	16,138	16,138
	Series G	3%	1985	42,002	9,660	51,662	43.2	5,166	6,695	8,803	15,499	15,499
019	Sturgis, Goshen & St. Louis	3%	1989	4	1	5	100.0	5	—	—	—	—
078	West Shore R.R. 1st	4%	2361	33,017	10,627	43,644	33.1	4,364	4,335	8,759	13,093	13,093
	Total Mortgage Bonds			589,077	185,130	774,207		77,424	135,010	97,249	232,262	232,262
	Collateral Trust Bonds											
	New York Central Bonds	5¼%	1980	173	75	248	100.0	25	75	—	74	74
	New York Central Bonds	5¾%	1980	454	213	667	86.1	67	172	28	200	200
	New York Central Bonds	6%	1980	18,298	8,669	26,967	62.7	2,697	5,072	3,018	8,090	8,090
	New York Central Notes	5%	1974	16,900	7,352	24,252	98.1	2,425	7,137	138	7,276	7,276
	New York Central Bonds	6%	1990	7,180	306	7,486	100.0	749	2,245	—	2,246(4)	2,246
	P.C. Bonds	6½%	1993	7,642	353	7,995	100.0	799	2,398	—	2,399(4)	2,399
	Total Collateral Trust Bonds			50,647	16,968	67,615		6,762	17,099	3,184	20,285	20,285
109	Chicago River and Indiana(3)			12,056	2,287	14,343	100.0	4,000	4,303	—	3,020	3,020
	Total Mortgage and Collateral Trust Bonds			651,780	204,385	856,165		88,186	156,412	100,433	255,567	255,567
	New Haven Claim			—Not Applicable—		121,000	79.3(2)	12,100	28,800	7,500	36,300	36,300
	Claims of Secured Bank Creditors			300,000	140,000	440,000	(2)	44,000	82,236	49,764	132,000	132,000
	Total Penn Central Transportation Co.			$951,780	$344,385	$1,417,165		$144,286	$267,448	$157,697	$423,867	$423,867

(1) Original principal of $6,647 increased by interest accrued during New Haven case.
(2) Settlement agreements which specify allocation of General Mortgage Bonds.
(3) Guaranteed by PCT and secured by deposit of PCTC bonds. The distribution is part of a settlement approved by the Court in Order No. 3420.
(4) These bondholders are to receive Series A Preference Stock which is entitled to priority.

TABLE I-A (cont'd)

Mortgage #	Issue	Rate	Year of Maturity	Claim: Principal	Claim: Interest	Claim: Total	Percent Secured by Retained Assets	Distribution: Cash	Distribution: Series A Bonds	Distribution: Series B Bonds	Distribution: Preference Stock	Distribution: New Common Stock
Secondary Debtors												
Cleveland & Pittsburgh												
216	Gen. & Ref. Mtg., Series C	3%	1974	$ 5,164	$ 1,201	$ 6,365	100.0%	$ 5,285	$ 360	—	$ 360	$ 360
C.C.C. & St. Louis												
040	Cin., Wabash & Mich. Div.	4%	1991	2,744	879	3,623	94.4	362	1,026	$ 61	1,087	1,087
033	General Gold, Series A	4%	1993	27,293	8,279	35,572	95.8	3,557	10,223	449	10,672	10,671
033	General, Series B	5%	1993	4,102	1,555	5,657	95.8	566	1,626	71	1,697	1,697
042	Ref. & Imp., Series E	4½%	1977	34,645	11,693	46,338	91.7	4,634	12,748	1,154	13,901	13,901
038	St. L. Div. 1st Col. Tr.	4%	1990	791	243	1,034	99.9	103	310	—	310	311
	Total C.C.C. & St. Louis			69,575	22,649	92,224		9,222	25,933	1,735	27,667	27,667
Connecting												
202	1st, Series A	3⅛%	1976	6,951	1,702	8,653	17.4	865	451	2,144	2,596	2,597
217	P. O. D. 1st Ref., Series E	2⅞%	1975	24,357	5,426	29,783	92.9	2,978	8,300	635	8,935	8,935
	Total Connecting			31,308	7,128	38,436		3,843	8,751	2,779	11,531	11,532
Michigan Central												
058	Ref. & Imp., Series C	4½%	1979	9,337	3,350	12,687	100.0	12,687	—	—	—	—
Northern Central												
209	1st Mortgage	6%		1,500	690	2,190	82.9	219	545	112	657	657
210	Gen. & Ref., Series A	5%	1974	8,300	3,251	11,551	53.8	1,155	1,865	1,601	3,465	3,465
210	Gen. & Ref., Series A	4½%	1974	6,431	2,267	8,698	53.8	870	1,404	1,206	2,609	2,609
	Total Northern Central			16,231	6,208	22,439		2,244	3,814	2,919	6,731	6,731
Penndel												
	Battle Creek & Sturgis 1st Mtg.	3%	1989	15	—	15	100.0	15	—	—	—	—
204	E. & W. Income Mtg.	5%	2862	155	60	215	100.0	215				
	Total Penndel			170	60	230		230				
Pitts., Youngstown & Ashtabula												
219	1st Gen., Series C	5%	1974	1,171	468	1,639	98.0(1)	226	983	—	215	215
219	1st Gen., Series D	4½%	1977	1,485	507	1,992	98.0(1)	274	1,195	—	262	261
	Total P., Y., & A.			2,656	975	3,631		500	2,178	—	477	476
Philadelphia, Baltimore & Washington												
213	Gen., Series B	5%	1974	10,000	3,958	13,958	29.7	1,396	1,246	2,942	4,187	4,187
213	Gen., Series C	4½%	1977	11,286	4,047	15,333	29.7	1,533	1,367	3,233	4,600	4,600
213	Gen., Series E	3%	1978	9,549	2,220	11,769	29.7	1,177	1,049	2,482	3,531	3,530
213	Gen., Series F	3½%	1979	13,792	3,701	17,493	29.7	1,749	1,559	3,689	5,248	5,248
218	PCC & St. L. Gen., Series A	5%	1970	813	29	842	50.7	84	128	125	253	252
218	PCC & St. L. Gen., Series B	5%	1975	25,665	9,945	35,610	50.7	3,561	5,422	5,261	10,683	10,683
218	PCC & St. L. Gen., Series E	3⅜%	1975	16,520	4,320	20,840	50.7	2,084	3,173	3,079	6,252	6,252
	Total P. B. & W.			87,625	28,220	115,845		11,584	13,944	20,811	34,754	34,752

(1) Settlement agreements which specify allocation of General Mortgage Bonds.

TABLE 1-A (cont'd)

Mortgage #	Issue	Rate	Year of Maturity	Claim: Principal	Claim: Interest	Claim: Total	Percent Secured by Retained Assets	Distribution: Cash	Distribution: Series A Bonds	Distribution: Series B Bonds	Distribution: Preference Stock	Distribution: New Common Stock
United New Jersey R.R. & Canal												
214	Gen. Mortg.	2¾%	1976	$ 5,669	$ 1,559	$ 7,228	72.7%	$ 723	$ 1,577	$ 592	$ 2,168	$ 2,168
214	Gen. Mortg.	4½%	1979	6,020	2,122	8,142	72.7	814	1,776	666	2,443	2,443
214	Gen. Mortg.	4½%	1973	1,824	784	2,608	72.7	261	568	215	782	782
214	Gen. Mortg.	3%	1973	6,487	2,335	8,822	72.7	882	1,924	722	2,647	2,647
207	NYB R.R. 1st, Series A	3¾%	1973	8,310	2,415	10,725	100.0	1,073	3,218	—	3,217	3,217
	Total United New Jersey R.R. & Canal			28,310	9,215	37,525		3,753	9,063	2,195	11,257	11,257
	Total Secondary Debtors			$ 250,376	$ 79,006	$ 329,382		$ 49,348	$ 64,043	$ 30,439	$ 92,777	$ 92,775
Other Leased Lines												
* *New York Connecting*												
208	1st, Series B	2⅞%	1975	$ 17,793	$ 3,965	$ 21,758	0.1	$ 2,176	$ 6	$ 6,522	$ 6,527	$ 6,527
* *Pennsylvania Tunnel & Terminal*												
212	Notes	4.9%	1991	47,000	6,163	53,163	41.0	5,316	6,534	9,415	15,949	15,949
* *Peoria & Eastern*												
086	Income Mortg.	4%	1990	2,445	685	3,130	42.2	313	396	543	939	939
	Total Other Leased Lines			$ 67,238	$ 10,813	$ 78,051		$ 7,805	$ 6,936	$ 16,480	$ 23,415	$ 23,415
	Total PCTC, Secondary Debtors, & Other Leased Lines			$1,269,394	$434,204	$1,824,598		$201,439	$338,427	$204,616	$540,059	$540,057

* Distribution dependent upon reaching agreement with interested parties and approval by the Court.

TABLE I-B
DISTRIBUTIONS TO CLASS O STOCKHOLDERS OF LEASED LINES
(Dollars in Thousands)

	Held by Public Stockholders			Distribution					
	Shares	Percent	Total Claim	Cash	Series A Bonds	Series B Bonds	Series B Preference Stock or Series C-2 notes, as indicated	CBI's	New Common Stock
Treated As Secured Creditors:									
Secondary Debtors									
Cleveland & Pittsburgh R.R. Co.									
Guaranteed 7%	161,297	71.82%	$16,280	$ 1,860	$ 5,062	—	$ 4,679	—	$ 4,679
Special Betterment	97,217	17.47	8,720	640	2,438	—	2,821	—	2,821
Delaware R.R. Co.	30,642	15.08	1,072	107	276	$ 45	322	—	322
Erie & Pittsburgh R.R. Co.	12,473	31.18	1,000	100	300	—	300	—	300
Michigan Central R.R. Co.	218	0.11	191	191	—	—	—	—	—
Philadelphia & Trenton R.R. Co.	2,637	20.95	461	47	74	64	138	—	138
Pitts. Ft. Wayne & Chicago Ry.									
Common	2,268	0.20	278	28	—	84	83	—	83
Preferred	149,880	76.12	23,119	3,555	5,692	—	6,936(1)	—	6,936
Original Guaranteed	180	100.00	28	4	7	—	8(1)	—	9
Guaranteed Special	1,810	100.00	222	22	—	66	67	—	67
Pitts. Youngstown & Ashtabula Ry.	22,200	24.42	3,200	320	960	—	960	—	960
United New Jersey R.R. & Canal Co.	97,440	45.87	17,052	1,705	—	5,116	5,116	—	5,115
Total Secondary Debtors			$71,623	$ 8,579	$14,809	$5,375	$21,430		$21,430
Other Leased Lines									
* Detroit Manufacturers' R.R.	556	18.53	49	5	—	14	15	—	15
* Little Miami R.R. Co.									
Capital	49,426	37.31	3,806	740	1,022	—	1,022	—	1,022
Special Betterment	29,847	19.07	1,045	447	200	—	199	—	199
* Mahoning Coal R.R. Co.									
Common	5,621	18.74	6,880	1,472	148	1,655	1,802	—	1,803
Preferred	2,119	16.02	145	145	—	—	—	—	—
* Peoria & Eastern Ry. Co.	19,914	19.93	1,564	157	—	469	469	—	469
Total Other Leased Lines			$13,489	$ 2,966	$ 1,370	$2,138	$ 3,507	—	$ 3,508
Total Treated as Secured Creditors			$85,112	$11,545	$16,179	$7,513	$24,937	—	$24,938
Treated As Unsecured Creditors:									
Beech Creek R.R. Co.	23,990	19.99	$ 852	—	—	—	—	$ 256	$ 852
C.C.C. & St. Louis R.R. Co.									
Common	2,481	0.53	440	—	—	—	—	132	440
Preferred	9,659	9.66	845	—	—	—	—	254	845
Northern Central Ry. Co.	125,014	19.88	8,751	—	—	—	—	2,625	8,751
Total Treated as Unsecured Creditors			$10,888	—	—	—	—	$3,267	$10,888
Total Claims of Public Stockholders of Leased Lines			$96,000	$11,545	$16,179	$7,513	$24,937	$3,267	$35,826

* Distributions dependent upon reaching agreements with interested parties and approval by the Court.

(1) Amounts reflect Series C-2 Notes, Not Series B Preference Stock.

Both A and B bonds are general obligations of the reorganized company, but the A bonds are scheduled to be paid off more quickly. Under the Plan, it is anticipated that \$304.9 million of the \$344 million in A bonds will be redeemed by 1980, and the balance will be paid by 1983; whereas, only about \$25.1 million of the \$223.1 million of B bonds (11.25% of those issued) will be paid in 1983. No additional redemptions are projected until the conclusion of the Valuation Case.

There appears to be general agreement that the differing characteristics of the A and B bonds, *i.e.*, their design features, are a reasonable reflection of the differences between retained and conveyed assets. But there is sharp disagreement as to whether the distributions proposed to be made to Class J creditors (the 10-triple-30 distribution scheme itself, and the allocation of A and B bonds within that scheme) adequately recognize the differences as between claimants secured by various percentages of retained assets.

The Trustees and the SEC are of the view that the Plan properly and fairly takes into account the extent to which particular claims are secured by retained assets. A group of Indenture Trustees and individual bondholders contend, however, that the Plan does not treat fairly those creditors whose claims are more than fully secured by retained assets. These objectors, who have come to be known as the "super secured" creditors, challenge the fairness and equity of the proposed 10-triple-30 distribution on two distinct grounds: (1) that the Plan does not accord fair and equitable treatment to the Class J claimants in relation to each other; and (2) that the Plan violates the absolute priority rule, since unsecured creditors and equity interests are allegedly permitted to particpate even though the secured creditors will not have received the full equivalent of their senior rights.

2. *"Super Secureds" Objections.*

a. Identifying the "Super Secured" Claims.

These objectors assert that a claim is entitled to the "super secured" label if it is secured by retained assets substantially in excess of 100% of the amount of the claim.[49] While this definition is easily stated, the complexities of the Penn Central debt structure are such that the definition is not easily applied. For one thing, the precise impact of marshalling concepts may be difficult to ascertain. For another, the relvance of the marshalling doctrine may fluctuate according to the context. Generally speaking, no creditor could expect to receive more than 100% of his claim on liquidation; thus, for purposes of the absolute priority rule, junior claimants are entitled to the benefits of marshalling principles. But when the issue is the relative treatment of secured creditors within the same class, and the focus is solely upon the extent to which one creditor's security happens to be retained assets, while another's happens to be conveyed assets, the applicability of marshalling principles in assessing their relative positions is less clear. If a creditor secured by retained assets is entitled to better treatment than one secured by conveyed assets, even though both are fully secured creditors, is not a claim which is 200% secured by retained assets relatively better off than a claim 110%-secured by retained assets?

Perhaps the easiest example of a "super secured" claim is the Mohawk & Malone 011 mortgage, which has retained assets coverage of 275% (a total claim of $1.967 million, secured by $4.535 million in escrowed cash and an additional $.85 million in retained physical assets).[50] Others

49. Claim in this context is principal plus interest through December 31, 1977.

50. Actulaly the 019 Sturgis, Goshen & St. Louis is the most super secured. The total claim is $5,000 and is secured by $749,000 in retained assets. (14,980% secured). As a matter of administrative convenience, this mortgage should be paid in full.

in the "super secured" category are the 027 Boston & Albany mortgage, with 116% retained asset coverage. Two collateral trust issues, the New York Central 6% bonds of 1990 (approximately 113% to 119% retained asset coverage) and the Penn Central 6½% bonds of 1993 (approximately 123% to 131% retained asset coverage), also have "super secured" status. In both cases, stock of the Pittsburgh & Lake Erie Railroad is the primary security.[51]

The situation is more complicated with respect to the New York Central mortgage chain of the 013, 014 and 015 mortgages. The amount of the 013 mortgage (the New York Central & Hudson Gold Bond Mortgage) is $97 million, but its total retained assets are approximately $236 million. Under the Trustees' analysis, the $139 million excess is marshalled down to the second level, the 014 New York Central & Hudson Consolidation Mortgage. Within the Consolidated Mortgage, the Lake Shore and the Michigan Central Collateral Indentures have first liens upon, and share *pari passu* this excess asset value from the Gold Bond Mortgage, while the Series A and C bonds under the Consolidation Mortgage come next, *pari passu*. The $139 million excess security from the Gold Bond Mortgage is adequate to render all four of the issues under the Consolidation Mortgage fully secured.[52] Thus, under the Plan, the Gold Bond and Consolidation Mortgages receive their full 30% in A bonds. The Michigan Central Collateral Indenture also has a lien on $25.195 million in Michigan Central stock, but since it is already fully secured by the excess Gold Bond asset values, the stock is passed down to

51. The lower percentages of retained assets are based on the Trustees' valuation of the P&LE stock and the higher percentages on the Indenture Trustees' estimates of the value of the stock.

52. Vol. II at 35, as amended by the Trustees' Brief at 190-96. *See* Section II-G-3-a-ii *infra*, for a discussion of the treatment of the Harlem leasehold.

the next level in the chain, the 015 New York Central & Hudson R & I Mortgage.

The Indenture Trustees of the Lake Shore and the Michigan Central Collateral Indentures claim that the retained asset security coverage for their issues is approximately 394% [53] in retained assets. They arrive at this figure by accepting the excess security values marshalled down from the Gold Bond Mortgage, and adding those values to the value of the Michigan Central stock; they do not, however, marshall down to the Series A and C bonds of the Consolidation Mortgage retained asset values in excess of the combined claims, $41.67 million, of the Lake Shore & Michigan Central Collateral Indentures. In other words, they wish to have the benefit of marshalling, while rejecting its burdens. That approach must be rejected.

In my view, for purposes of determining "super secured" status, only the assets directly attributable to a particular mortgage should be considered. Therefore, the 013 Gold Bond Mortgage should have the benefit of the entire $236 million in retained assets. It is therefore entitled to claim retained asset coverage of 243%. Under this approach, the Michigan Central Collateral Indenture would have the benefit of the pledged Michigan Central collateral stock, and thus would have retained asset coverage of 115%. But the Lake Shore collateral trust would have no retained coverage.

53. Under the revised marshalling analysis $139 million is passed down from the Gold Bond Mortgage to the Consolidation Mortgage. The Lake Shore and the Michigan Central Collaterals have the first lien on this $139 million. In addition, the Michigan Central Collateral has a first lien on Michigan Central stock valued at $25.195 million. Thus, the Lake Shore and the Michigan Collaterals have a first lien on $164.21 million in retained assets, but the combined claims of the two collaterals is only $41.67 million ($164.21/41.67 # 394%).

b. The Alleged Disparities in Treatment.

In order to understand and evaluate the "super secured" claimants' challenges to the fairness and equity of the relative treatment of secured creditors under the Plan, it is necessary to analyze precisely how the 10-triple-30 formula works out. Table 2 below sets forth hypotheical examples showing how the proposed distribution scheme operates.[54] (The B bond distributions are shown as of consummation date, and do not reflect the fact that 11.25% are expected to be redeemed in 1983.)

TABLE 2

		Retained Assets as a Percentage	Distribution				Cash & A Bonds as a Percentage of		Percentage of Retained Assets Not
Mtg.	Claim	of Claim	Cash	A Bonds	B Bonds	Cash & A Bonds	Claim	Retained Assets	Recovered
A	$100	275%	$10	$30		$40	40 %	14.54%	85.46%
B	100	243	10	30		40	40	16.46	83.54
C	100	120	10	30		40	40	33	67
D	100	100	10	30		40	40	40	60
E	100	75	10	22.5	$ 7.5	32.5	32.5	43	57
F	100	50	10	15	15	25	25	50	50
G	100	25	10	7.5	22.5	17.5	17.5	70	30
H	100	15	10	4.5	25.5	14.5	14.5	97	3
I	100	10	10	3	27	13	13	130	0

Several comments may be made about the conclusions to be derived from the foregoing table. Unquestionably, the preferred distributions of cash and A bonds do not precisely reflect the differences in retained asset coverage, whether the distributions be considered in terms of percentage of the claim, or in terms of percentage of retained assets securing the claim. A mortgage secured 50% by retained assets receives $25 in cash and A bonds per $100 of claim ($26.69 if the 1983 redemption of B bonds is

54. Tables 2 through 6 are based on the same hypothetical facts: the claims of secured creditors total $900, retained assets have a total value of $913, and there is $172.50 in A bonds and $90 in cash to be distributed. These tables are used for the purpose of illustrating the ten-triple-30 distribution under the Plan, and the Alternate Distribution Scheme.

included), whereas a mortgage of 100%-secured by retained assets receives $40 per $100 of claim. Thus, the 50%-secured mortgage receives 62.5%, rather than 50%, of what the 100%-secured mortgage receives. Moreover, all mortgages with retained asset coverage of 100% or better are treated exactly the same.

Columns 8 and 9 of Table 2 show that the more a claim is secured by retained assets, the greater the percentage of the claim which is to be satisfied in cash and A bonds. On the other hand, the less a claim is secured by retained assets, the greater will be its percentage of retained asset security recovered. The final column expresses the same point in different terms: The higher the retained asset coverage, the higher the percentage of retained assets used to satisfy other claimants.

Table 2 demonstrates the impact of disregarding retained assets in excess of 100% of the claim. But it can also be contended that the proposal to pay all Class J creditors 10% of their claims in cash has adverse consequences for the "super secured" claimants. This impact is not easy to quantify, but it is helpful to analyze the distributions of A bonds alone, without regard to the cash distribution. Table 3 below illustrates this analysis:

TABLE 3

Mtg.	*Claim*	*Retained Assets as a Percentage of Claim*	*A Bonds*	*A Bonds as a Percentage of Claim*	*Percentage of Retained Assets Recovered*	*Percentage of Retained Assets Not Recovered*
A	$100	275%	$30	30 %	11 %	89 %
B	100	243	30	30	12.3	87.7
C	100	120	30	30	25	75
D	100	100	30	30	30	70
E	100	75	22.5	22.5	30	70
F	100	50	15	15	30	70
G	100	25	7.5	7.5	30	70
H	100	15	4.5	4.5	30	70
I	100	10	3	3	30	70

By comparing the "percentage of retained assets recovered" as shown on Tables 2 and 3, the impact of the 10% cash payment is highlighted. In the allocation of A bonds, as shown on Table 3 the difference between the 50%-secured mortgage and the 275%-secured mortgage is 19 percentage points in recovered assets, whereas the difference is 35.5 percentage points when the cash distribution is included, as shown on Table 2.

Table 3 is a clear reflection of the concepts underlying the A-B bond allocations. The methodology is that of the conventional going-concern reorganization, *i.e.*, determine who is secured in what amount by valuing the assets and marshalling excess values, and then proportionately distribute debt securities in amounts consistent with a sound capital structure. All mortgages secured 100% or better are treated equally. The disparity in percentages of retained assets recovered is attributable to the application of marshalling principles.

It is apparent, therefore, that the distributions under the Plan which are based on retained assets will not correspond to the amount of retained assets securing a particular claim, and that the disparity is attributable in part to the 10% cash distribution to all Class J creditors, and in part to the A-B bond allocation formula.

c. The Proposed Alternate Distribution Scheme.

The fundamental contention of the "super secured" claimants is that the Plan should allocate cash and A bonds so as to give direct and complete recognition to the fact that their claims are secured by retained assets in excess of the amount of the claim. Tables 4 and 5 illustrate how such a distribution scheme might work (the Alternate Distribution Scheme). Simply stated, the total of retained asset security is compared to the total amount of A bonds

or A bonds plus cash to be distributed. The percentage of the total retained assets attributable to a particular mortgage is then obtained, and applied to the amount to be distributed.

Another method of achieving the same result is to divide the fund to be distributed (A bonds, or cash plus A bonds) by the total retained assets. The percentage thus obtained is then applied to dollars of retained assets attributable to each mortgage. This latter method is more convenient when the amounts of the respective mortgage claims differ.

Table 4 shows the distribution of A bonds under the Alternate Distribution Scheme; Table 5 shows the distribution of cash and A bonds under the Alternate Distribution Scheme; and Table 6 compares these Alternate Distribution Scheme distributions with that proposed in the Plan (Table 2).

TABLE 4

A Bond Distribtuion Under the Alternative Distribution Scheme

Mtg.	*Claim*	*Retained Assets as Percentage of Claim*	*Retained Assets as a Percentage of All Retained*	*Distribution of A Bonds*	*Distribution as a Percentage of Claim*	*Percentage of Retained Assets Recovered*	*Percentage of Retained Assets Not Recovered*
A	$100	275%	30.00%	$51.75	51.75%	19%	81%
B	100	243	26.60	46.00	46.00	19	81
C	100	120	13.00	22.42	22.42	19	81
D	100	100	11.00	19.00	19.00	19	81
E	100	75	8.21	14.20	14.20	19	81
F	100	50	5.48	9.50	9.50	19	81
G	100	25	2.74	4.72	4.72	19	81
H	100	15	1.64	2.82	2.82	19	81
I	100	10	1.10	1.89	1.89	19	81

TABLE 5

Distribution of Cash and A Bonds Under the Alternate Distribution Scheme

Mtg.	*Claim*	*Retained Assets as a Percentage of Claim*	*Retained Assets as a Percentage of All Retained*	*Distribution of Cash & A Bonds*	*Distribution as a Percentage of Claim*	*Percentage of Retained Assets Recovered*	*Percentage of Retained Assets Not Recovered*
A	$100	275%	30.00%	$78.75	78.75%	28.75%	71.25%
B	100	243	26.60	69.82	69.82	28.75	71.25
C	100	120	13.00	34.10	34.10	28.75	71.25
D	100	100	11.00	28.75	28.75	28.75	71.25
E	100	75	8.21	21.55	21.55	28.75	71.25
F	100	50	5.48	14.39	14.39	28.75	71.25
G	100	25	2.74	7.20	7.20	28.75	71.25
H	100	15	1.64	4.31	4.31	28.75	71.25
I	100	10	1.10	2.80	2.80	28.75	71.25

TABLE 6

Comparison of Cash and A Bonds Distribution Under the Plan and Under the Alternate Distribution Scheme

Mtg.	*Claim*	*Retained Assets as a Percentage of Claim*	*Plan Distribution of Cash & A Bonds as a Percentage of Claim*	*Alternative Distribution Scheme Cash & A Bonds as a Percentage of Claim*	*Increase or Decrease in Percentage of Claim Satisfied in Cash and A Bonds*
A	$100	275%	40.00%	78.75%	38.75%
B	100	243	40.00	69.82	29.82
C	100	120	40.00	34.10	(5.9)
D	100	100	40.00	28.75	(11.25)
E	100	75	32.50	21.55	(10.95)
F	100	50	25.00	14.39	(10.61)
G	100	25	17.50	7.20	(10.3)
H	100	15	14.50	4.31	(10.19)
I	100	10	13.00	2.80	(10.2)

The foregoing tables (2 through 6) show retained asset coverage without regard to marshalling. The distri-

butions under the Plan, on the other hand, are based upon the Trustees' marshalling analysis. If marshalling were eliminated in calculating the distribution under the Plan, the percentage of retained asset security of the following Penn Central mortgages would be substantially affected:

(000's omitted)

Mortgage	*Claim*	*% Secured Under The Plan*	*% Secured Under Alternate Distribution Scheme*
012 Mohawk & Malone	$ 3,920	87%	0%
014 Lake Shore Collateral	19,815	100	0
014 Series A 4%	82,939	100	0
014 Series C 4%	14,496	100	0
015 NYC & Hudson R & I	271,000	36	27

Moreover, various collateral trust secured by these bonds would also be affected. Elimination of marshalling would leave approximately $146.36 million in retained assets for application to higher lien levels. Since the Alternate Distribution Scheme would be used to distribute a combined total of cash and A bonds, mortgages with no retained assets would receive only B bonds. It is important to note also that, because the Alternate Distribution Scheme would distribute to some claimants cash and A bonds in excess of 40% of their claims, the distribution of preferred and common stock would have to be adjusted, and a related adjustment would have to be made for all other B bond recipients, because the total of B bonds available would be substantially less than the dollar amounts of claims to be satisfied.

It is manifest, therefore, that this Alternate Distribution Scheme cannot be implemented as merely as adjustment to the 10-triple-30 formula of the existing Plan. Rather, an entire new Plan would be required.

d. Tracing Retained Asset Values.

It is argued that the Plan is unfair because funds which should go to pay the claims of the "super secured" creditors will be used instead to pay mortgages less well secured. This would be true only if it can be shown that some mortgage creditors would receive cash and A bonds in excess of the value of the retained assets securing their particular mortgages. But the instances in which this result can be said to occur are rare, and the amounts involved negligible. As shown in Table 2 above, a mortgage 15% secured by retained assets would receive cash and A bonds totaling $14.5 per $100 of claim; even reflecting the early redemption of 11.25% of the B bonds, the total distribution would barely exceed the retained assets.

There appear to be only three mortgages as to which the Plan proposes distribution of cash, A bonds, plus 11.25% of the B bonds having a combined total in excess of the amount of retained assets securing the mortgages. These are the New Jersey Junction First Mortgage, where the excess is approximately $112,650; the New York & Putnam, where the excess is $104,600, and the Connecting Railway, where the excess is $89,360. The problem arises only with respect to mortgages which are less than about 18% secured by retained assets. The total amount by which cash, A bond, and early B bond redemption distributions to mortagees would exceed the retained assets securing these mortgages would be only $306,610, an amount which, in this context, may be disregarded as *de minimis*.

Since the retained asset values which justify the "super secured" label are not being distributed to other mortgage claimants, the question naturally arises, to whom will these values be distributed? For the most part, as noted above, retained asset proceeds will be used to fund the Plan provisions for the claims of the United States and

the claims of state and local taxing authorities. The super secured claimants, as pre-bankruptcy creditors, cannot successfully object to that use of retained asset values. But the use of retained assets to satisfy the claims of the New Haven Trustee and of the secured bank group would raise additional issues, and it is therefore necessary to determine whether the Plan would have that effect.

I have concluded that the distributions proposed in the Plan would not result in the use of retained assets securing the mortgages of the "super secured" claimants to satisfy the claims of the New Haven Trustee. Under the settlement with the New Haven Trustee, that claim is liquidated as a secured claim in the amount of $121 million, and as an unsecured claim in the amount of $53 million. Moreover, the $121 million secured portion of the claim is to be treated as if it were secured by $96 million in retained assets (*i.e.*, 79% secured by retained assets). The actual retained assets securing the New Haven Trustee's divisional mortgage is $48.17 million.

Under the Plan, the New Haven Trustee would receive the following distribution: $12.1 million in cash; $28.8 million in A bonds; $7.5 million in B bonds; $36.3 million in preference stock; and $36.3 million in common stock. The total of cash and A bonds is $40.9 million. Assuming 11.25% of the B bonds are redeemed on schedule, the total of the relatively immediate distribution would be $41.75 million, which is still about $6.4 million less than the retained assets securing the divisional mortgage.

The claim of the secured banks stands on a different footing; in a sense, satisfaction of their claims does involve use of retained assets of the super secured claimants. The security for the banks' claims is the pledge of the Pennco stock. Pursuant to the compromise settlement, the secured banks' claim is liquidated as a secured claim in the amount of $440 million, but the agreed-upon distribution under the Plan is based upon retained asset coverage of 61%. Thus, the distribution would be $44 million in cash; $80.52 million in A bonds; $51.48 million in B bonds; $132 million in preferred stock; and $132 million in common stock. The total of cash and A bonds is $124.5 million, and with the addition of 11.25% of the B bonds, the total comes to $130.3 million. Since the retention of Pennco as the core of the reorganized company is essential to reorganization, and since the appraised value of Pennco is greater than the $440 million claim of the secured banks, the proposed treatment is appropriate. But since Pennco is to be retained, the banks, collateral will not be sold. Therefore, the money to fund the cash and A bond distribution to the banks must come from available assets. In these circumstances, it is preferable to assume, for analytical purposes, that this distribution to the secured banks involves the use of retained assets (even though there is actually unencumbered cash on hand in excess of the immediate distribution to the banks).

Of course, as Table 2 demonstrates, the retained assets of all secured creditors rather than just those of the super secureds, are being used in the Plan to satisfy other claimants. The secured banks' distribution is simply a portion of the claims which are satisfied by retained assets of others. It is true, however, that the percentage contribution of retained assets is not uniform—the higher the retained asset coverage, the higher the percentage of retained assets used to satisfy other claims.

At first blush, the Alternate Distribution Scheme appears to be correct because each mortgage recovers a uniform percentage of its retained assets and also contributes a uniform percentage for other purposes under the Plan. However, there is a fundamental fallacy in the super secureds' position. Implicit in their argument is the assump-

tion that application of the uniform percentage arrangement would produce a fund adequate to satisfy these priority claims. As the SEC has pointed out, that assumption is simply wrong.

Under the Plan, $667.9 million of administration claims would be paid from cash on hand or the proceeds of the Asset Distribution Program.[55] Claims of the United States and the taxing authorities totaling $502.6 million would be deferred until the conclusion of the Valuation Case, and would be paid from the proceeds of that litigation, ahead of the B bonds which are distributed to those not fully secured by retained assets. During the deferral period, $481.3 million in interest would accrue on these claims. The Alternate Distribution Scheme totally disregards the deferral of $502.6 million in principal and also, in effect, charges the $481.3 million in accrued interest against the B bond recovery. However, it is clear that the super secured claimants benefit from this deferral, and that the Alternate Distribution Scheme would provide them this benefit without any cost. What the Plan does, on the other hand, is to compensate the lesser-secured mortgages for the subordination of their claims to almost $1 billion in administration expenses by providing the 10% cash distribution plus some portion of 30% of their claim in A bonds.[56] I am satisfied that such treatment of the lesser-secured mortgages is fair and equitable.

e. Liquidation Analogy.

Some of the super secured claimants have presented additional arguments in an attempt to demonstrate that

55. Figure includes principal and interest payments on securities issued to administration claimants. Total cash expended under Plan through 1987 is $1,345.6 million, but of this amount, $677.7 million is paid to Class J secured creditors and the balance of $667.9 million is paid to administration claimants.

56. "Lesser secured' in the sense that their security is other than retained assets.

the Plan allocation of administration expenses between retained and conveyed assets is unfair. They contend that, even if there is no recovery at all in the Valuation Case, their mortgages would nevertheless be paid in full on liquidation. I have concluded, however, that the tendered liquidation analysis is not entirely correct, and that the Plan would not be unfair even if it were correct.

The most complete liquidation analysis has been presented by the Manufacturers National Bank of Detroit (hereinafter Detroit Bank), the Indenture Trustee of the Lake Shore Collateral Trust Mortgage.[57] As noted above, the Lake Shore Collateral Trust Mortgage is not actually "super secured" if the excess collateral of the 013 Gold Bond Mortgage is retained at the Gold Bond Mortgage level. But if marshalling principles are applied, the Lake Shore Collateral Trust Mortgage is super secured. Marshalling would be appropriate in the event of liquidation, and the Detroit Bank's assumption that the Lake Shore collateral is super secured is a valid assumption for purposes of the liquidation analysis.

The Detroit Bank's liquidation analysis proceeds as follows: First, all leased line assets and all leased line claims against the Penn Central estate are disregarded. Next, the $498 million of unencumbered assets are applied to the payment of administration expenses, leaving a balance of $615.1 million unpaid. Then, the crucial assumption is made that $299.7 million of the unpaid administration claims, representing tax claims against conveyed assets, would have no claim against retained assets, and can therefore be eliminated from consideration. On this assumption, the amount of administration claims chargeable against retained assets would be reduced to $315.4 million, or about 34% of the total retained assets. Each mortgage is then charged with its 34% share of the shortfall.

57. Document No. 14220.

For the 013-014 mortgage chain, this works out to $104.2 million, leaving $201.3 million in retained assets available for that mortgage chain (assuming the validity of the Detroit Bank's $44.29 million increase in the assets of the 013-014 mortgage chain[58]). Since the amount needed to satisfy the Gold Bond Mortgage, as well as the Michigan Central and the Lake Shore Collaterals, is $138.7 million, there would be a balance of $62 million in retained assets.

But if the tax claims against conveyed assets cannot be simply relegated to the proceeds of the Valuation Case (that is, if they, too, can look to retained assets on liquidation) then the balance of administration claims would represent 66% of the total retained assets. This would be $201.63 million in the case of the 013-014 mortgage chain, and would leave only $103.87 million in retained assets for that chain, well short of the $38.7 million needed to satisfy all of the mortgages in full. Moreover, if the Trustees' figure of $236 million in retained assets is used, only $80.24 million would be available for the satisfaction of the 013 Gold Bond Mortgage, and nothing would pass down to the 014 Consolidation Mortgage level.

Thus, the Detroit Bank, like so many other creditors in this proceeding, has staked out a legal position based upon the assumption that all disputed issues should be resolved in its favor. While there is nothing wrong with considering what the possible results of a liquidation might be on a "best case" basis, it is also necessary to take into account "worst case" assumptions before deciding whether the adjustments represented by the Plan are fair and equitable.

58. The increment is produced by crediting to the 013 Gold Bond Mortgage with a substantially larger amount for its lien on the Harlem leasehold. *See* Section II-G-3-a-ii *supra*.

A further weakness in much of the liquidation analysis is that the significance of time is reflected only by discounting the projected sale value of the retained assets, whereas time has several other important consequences. Apparently recognizing this deficiency, the Detroit Bank has submitted what it calls a "Cash Flow Scenario as of December 31, 1980."[59] This purports to show that, by December 31, 1980, $124.7 million of the claims represented by the 013-014 mortgage chain could be paid in cash. The analysis proceeds as follows: By the end of 1980, there would be $286 million in unencumbered cash. After exclusion of the $299.7 million in taxes on conveyed assets, the administration expenses would be $753.1 million, leaving an aggregate shortfall of $467.1 million. But there would be $845.1 million derived from the sales of retained assets during this period, so that a total of $378 million would be available for distribution to secured creditors. The proportionate share of the fund available for the 013-014 mortgage chain, on a percentage basis, would be $124.7 million.

One rather obvious flaw in this reasoning is that the running of the interest on claims during the three-year period is ignored. For example, even if low rates of interest are assumed administration claims would increase by about $130 million. This alone would reduce the potential distribution to the 013-014 mortgage chain to about $81 million, without allowing for the additional $8 million in interest which would have accrued on the 013 Gold Bond Mortgage.[60] (It is not clear whether the Detroit

59. Appendix E to Doc. No. 14220.

60. After applying all unencumbered cash, $136 million, the balance of the administration claims is $617.1 million. If interest is accrued on the $617.1 million at 7.5% compounded annually and the Detroit Bank's forecasted additional unencumbered assets from the Asset Disposition Program, $150 million, are credited at the

Bank's projected asset disposition proceeds include interest which would be earned by those proceeds pending distribution at the end of 1980. If not, the foregoing disparity would be reduced to the aggregate of the differential between interest earned on the proceeds and interest accruing on the administration claims).[61]

There are additional reasons for not taking this cash flow analysis too seriously. Exclusion of the $299.7 million in taxes on conveyed assets is subject to the same criticisms discussed in connection with the liquidation analysis. If these taxes must be included, additional interest during the three-year period would increase this claim by at least $67.45 million.[62]

Aside from the merits of the exclusion of the tax claims on conveyed property, there is another equally important consideration. There is no justification for proceeding on the assumption that the propriety of the exclusion of the taxes on conveyed assets would be finally litigated by the end of 1980. In the event of actual liquidation, it is at least highly doubtful that these legal issues could be decided before the final outcome of the Valuation Case. Needless to say, it is precisely this kind of delay that the Plan is designed to avoid.

60. (Cont'd.)

early date of July 1, 1979, the resulting amount of administration claims as of December 31, 1980, is about $600 million. After the forecasted available Asset Disposition Proceeds of $845.1 million are applied, $245 million in cash is available. Using Detroit Bank's allocation of 33% to the 013 Gold Bond Mortgage, $81 million would be available.

61. In the Trustees' cash forecast earnings are calculated at a 6% rate. On the other hand, the § 211(h) claim interest rate is assumed to be approximately 7.5%, and tax claim interest varies from 6% to 12%.

62. Assume a low interest rate of 7% compounded annually for three years.

Detroit Bank's cash flow analysis also overlooks the very real problems of determining the proper allocation to each mortgage of its appropriate share of administration expenses. The analysis applies across-the-board percentages. But the parties affected would have the right to contend, as indeed some of the super secured claimants themselves have argued, that the proper allocation should reflect differences in the extent to which particular mortgages did or did not benefit from the operation of the estate during the period in which the administration claims accrued. Implementation of this concept would require extremely complicated segregation studies, and would be protracted.

In addition to these problems of possible delay in achieving a distribution, the cash flow analysis contains a rather obvious and fatal flaw in its revenue assumptions. The projections assume that Pennco would be sold for $483 million, and that the proceeds would be available for the satisfaction of administration claims. (If either of these assumptions is invalid, there would be only $362.1 million in cash by December 31, 1980, to satisfy $467.1 million in administration claims). As noted in discussing the claims of taxing authorities (Section II-F), the secured banks could certainly be expected to argue that administration expenses may not be allocated against non-operating collateral such as the Pennco stock; and that the Debtor had no equity in the pledged collateral. They would no doubt also make the somewhat related argument that they could properly look to their own collateral and not be forced to commingle it (as the cash flow scenario assumes).

If Detroit Bank's cash flow analysis is considered on a "worst case" basis, a very different picture emerges. If the tax claims against conveyed assets must be recognized (either by payment, or by setting up reserves to guard

against deficiencies in the Valuation Case recovery) and if proceeds from the sale of the Pennco stock could not be made available, there would be $766 million in unpaid administration expenses,[63] against $362 million in retained asset proceeds,[64] or a shortfall of $404 million; and this without reflecting the increases in administration claims caused by delay in payment. But according to all of the projections, the total, undiscounted, proceeds from the Asset Disposition Program from 1981 through 1987 would be slightly more than $142.5 million.[65]

The Irving Trust Company, Indenture Trustee for the two collateral trust issues, the New York Central 6% Bonds of 1990 and the Penn Central 6½% Bonds of 1993, is in a somewhat different position from that of the other "super secured" claimants, and has presented a slightly different liquidation-analogy argument. Its primary collateral is a block of stock in an operating railroad, the Pittsburgh & Lake Erie. The relationship between the P&LE and Penn Central is, of course, somewhat different from the relationship between Pennco and Penn Central (the fortunes of P&LE being more directly intertwined with the rail operations of Penn Central), but in many ways the two collateral trust issues and the claim of the Secured Banks based upon the Pennco pledge are similarly situated. In both cases,

63. Add back to the $467.1 million in administration claims (after application of all unencumbered assets) the $299.7 million in tax claims for a total of $766.8 million.

64. Reduce Detroit Bank's projected available cash from sale of retained assets, $845.1 million, by $483 million, the projected proceeds of the sale of the Pennco stock.

65. Over $64 million of the $142.5 million is projected to be from the sale of the stock of the Pittsburgh & Lake Erie Railroad Company. Twenty-five percent of that stock is pledged under two collateral trusts. Irving Trust Company, Trustee for both issues, has asserted arguments similar to those of the Secured Banks outlined in the text above. Thus, on worst case assumptions, the $142.5 million would be overstated by about $16 million.

the collateral consists of non-operating property, and there is thus some basis for arguing that the collateral may not be invaded to pay administration expenses. In effect, Irving Trust Company adopts this argument, by allocating all tax claims to the various properties against which the taxes were assessed, and by showing that the Government's § 211(h) claims ($349 million), the trustees certificates and other administration expenses could probably be met from unencumbered assets.

Here again, however, timing is a factor. The Trustees' cash forecast contemplates that all of the P&LE stock, both pledged and unpledged, will be sold by 1983. This may or may not occur. But even assuming that the pledged stock could be sold immediately, it would not necessarily follow that the proceeds would immediately be available for satisfaction of the collateral trust obligations. Not only would litigation concerning their vulnerability to administration expenses be likely, but even assuming that only the Government's § 211(h) claims were held to prime the collateral trust claims, actual payment of the latter might have to come from later sales of other retained assets.

Although these and other difficulties render Irving Trust's arguments less than fully persuasive, it must nevertheless be acknowledged that the collateral trust do stand in a somewhat better position than other creditors whose claims are secured, in the same or lesser percentages, by retained operating assets.

f. Comparison with General Creditors and Equity Interests

Under the Plan, general unsecured creditors would receive certificates of beneficial interest in amounts equal to 30% of their claims, plus a pro rata allocation of 35% of the shares of common stock of the reorganized company.

Ten percent of the common stock of the reorganized company would be distributed to the equity holder (*i.e.*, Penn Central Company); no other distribution would be made to equity interests. Some of the "super secured" claimants argue that the Plan is unfair because these junior claimants are permitted to participate even though the secured claimants will not have received satisfaction in full.

As a preliminary matter, it should be noted that the participation of junior debt and equity interests is limited to contingent debt securities and equity interests; that is, no cash would be diverted to these junior claimants, nor would they receive higher-ranking securities than the senior claimants.

There can be no quarrel with the general proposition that a plan of reorganization cannot provide for participation by unsecured creditors and equity interests unless it provides to secured creditors full compensation for the rights discharged pursuant to the Plan. *Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. 510, 61 S. Ct. 675, 85 L. Ed. 982 (1941); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 318 U.S. 523, 63 S. Ct. 727, 87 L. Ed. 959 (1943). The passage of the RRRA did not abrogate the absolute priority rule. But it clearly has made it difficult to apply traditional methods of valuing the earning power of the reorganized enterprise and hence to determine whether what the secured creditors receive is equivalent to what they give up. The actual dollar value of the securities of the new company could not be fixed with even the minimal degree of precision encountered in ordinary reorganization plans until the Valuation Case litigation is concluded. Moreover, the unprecedented accumulation of unpaid administration claims, caused by the RRRA process, casts a pall of doubt over all pre-bankruptcy claims of creditors. In short, the

RRRA has made it difficult to determine both the "value" of the securities to be distributed to creditors under the Plan, and the "value" of what each creditor would be surrendering in exchange for those securities.

In attempting to show that Plan is unfair to them, the super secured claimants have mounted an extensive argument which focuses upon the uncertain value of the proposed new securities, but which assumes that their own claims are unassailable. This results in a distorted comparison between the claims surrendered and the benefits which would be received. Each claim is valued at its face value, principal plus interest. The 10-triple-30 securities package is valued as follows: cash at face value; A bonds at 75.6% of face value because of the delay in payment; common stock at $6 per share; and preference stock at $5 per share—$1 for the conversion feature and $4 for the redemption feature. Assuming the securities will have those values, each secured creditor will receive only $44.23 in present value for every $100 of claim surrendered. (If the preference stock is valued at its discounted value on the assumption that it will be redeemed in 1987, the value of the securities package increases to $50.53 per $100 of claim.) It is argued that because the value of the securities to be issued is less than the amount of the claim surrendered, it is impermissible to allow unsecured and equity interests to participate. This argument assumes all of the benefits of the Plan (the compromises with the Government, the bank group, the New Haven Trustee, and the taxing authorities) for purposes of valuing the claims at full value, but assumes that the Valuation Case will make no contribution whatever to the value of the common stock of the reorganized company (the $6 per share is arrived at by capitalizing 1978 earnings of the reorganized company).

This argument proves only that which was already obvious, namely, that if it must be assumed that there will be no recovery in the Valuation Case litigation, aspects of this Plan could not be approved. But it is also perfectly clear that no court could rationally make a finding, on this record, that the claims being litigated in the Special Court are without value. It is therefore impossible to conclude that the estate is insolvent, and that unsecured creditors and equity interests are not entitled to participate at all.

That being so, it is clear that the super secured claimants' argument merely again presents the same question under a different guise, namely, should a plan be attempted now, or should the results of the Valuation Case be awaited? This is perhaps the only question as to which there appears to be unanimous agreement: Everyone, including the super secured claimants, recognizes the desirability of achieving a plan now, rather than awaiting further developments.

Thus, the immediate issue is whether the risks, uncertainties and possible benefits of the Valuation Case litigation, and the consequences of the RRRA process, are being fairly apportioned in the distributions proposed in the Plan. I am satisfied that the allocations are fair and equitable.

Using the approach adopted by the super secured claimants, if the common stock of the reorganized company (ignoring the Valuation Case) is worth $6 per share, this means that the total value being distributed to unsecured claimants and equity interests aggregates only $62.5 million. It means that unsecured creditors would be paying about $88.90 of claim for each share of common stock, whereas the secured creditors would be paying about $44.55 of claim per share of stock, without regard to conversion of B bonds and preference stock.

Admittedly, if the results of the Valuation Case litigation are disastrously low, it will appear in retrospect that the unsecured creditors and equity holders will have received somewhat better treatment than they should have received. But on any reasonable assessment of the probable Valuation Case recovery, the balance between secured interests and unsecured/equity interests will be approximately correct. And if the recovery is sufficient to fund the CBIs and contribute additional value to the common stock, the secured creditors, as holders of 55% of the common stock, will surely have no grounds for complaint.

The foregoing discussion leads to the conclusion that, generally speaking, the "super secured" creditors as a group receive appropriate allocations of retained assets for purposes of the A-B bond distributions under the Plan. All have retained asset coverage in excess of 100% of the amounts of their claims, and the Plan accords the same treatment to all of these creditors. But while all of these creditors are on an equal footing, there is some merit in the suggestion that, in the vernacular, some are more equal than others. The Mohawk & Malone (011) mortgage has 275% retained asset coverage, and the Gold Bond Mortgage has 243% retained asset coverage. The New York Central 6% bonds of 1990 and the Penn Central 6½% bonds of 1993 have retained asset coverage of approximately 119% and 131% respectively, and they have the further advantage of the pledge of the Pittsburgh & Lake Erie stock. In my judgment, it would be preferable to accord claimants under these four mortgages somewhat better treatment than the Plan provides, if that can be accomplished within the contours of the present Plan.

For these reasons discussed above, I am satisfied that no "super secured" claimant can properly lay claim to more

cash or A bonds than the Plan provides. The alternative distribution scheme is invalid, and would not work. But within the framework of the present Plan, there is some room for flexibility in the handling of preference stock. Under the Plan, the selection of preference stock to be redeemed first is to be made by lot. While this is eminently fair as among holders similarly situated, it could, in actual operation, allow holders less favorably situated than the bondholders of these four mortgages to receive satisfaction of their claims before these more favorably situated bondholders. To prevent such an eventuality, in my judgment the solution is simply to include provisions guaranteeing that the holders of preference stock issued in exchange for the surrender of claims under the four mortgages listed above will have rights of redemption *pari passu* which take precedence over the redemption rights of other preference shares.

3. Disputes Involving the Retained Asset Analysis

Although each mortgage is treated as fully secured, the amount of A and B bonds to be distributed to the bondholders depends on the retained asset coverage of each mortgage. A number of the indenture trustees contend that their bondholders are entitled to a greater portion of A bonds because the Trustees' retained asset analysis incorrectly understates the amount of retained assets subject to the respective mortgage.

a. The R & I Mortgage

The Indenture Trustee of the R & I Mortgage contends that retained assets in six separate categories are either improperly omitted, or inadequately reflected, in the analysis of the retained asset coverage of the R & I Mortgage: (a) chargebacks for operating losses against Michigan Central and the Big Four; (b) the Harlem leasehold; (c) rents from Park Avenue properties and dividends on the Harlem stock; (d) interest on the Beech Creek, Harlem and Big Four bonds; (e) prebankruptcy sales; and (f) lien rights of matured bonds. Each of these categories must now be considered.

i. Chargeback against Michigan Central and Big Four for Operating Losses

Railroad leases are executory contracts which may be either adopted or rejected in the course of reorganization, and which, in any event, may be rejected in the Plan. When a lease is rejected, the rejection dates back to the filing of the petition in bankruptcy. In such circumstances, the lessee ordinarily operates the line "for the account of" the lessor. See § 77(c)(6). If the operation of the line for the account of the lessor produces operating losses (the usual case, else the lease would not be rejected) the lessee has a claim against the lessor for the amount of these losses. That claim (referred to herein as the "chargeback"), in the case of a bankrupt lessor, ranks as a claim of administration, having priority over all other claims against the estate, secured or unsecured. (By contrast, the lessor's claim against the lessee for the breach of contract which rejection of the lease entails is merely an unsecured prebankruptcy claim against the lessee's estate.) *See generally Warren v. Palmer,* 310 U.S. 132, 60 S. Ct. 865, 84 L. Ed. 1118 (1940); *Palmer v. Palmer,* 104 F.2d 161 (2d Cir.), *cert. denied,* 308 U.S. 590, 60 S. Ct. 120, 84 L. Ed. 494 (1939). *See also* Meck & Masten, *Railroad Leases and Reorganization: I,* 49 Yale L.J. 626 (1940); Meck, *Railroad Leases and Reorganization: II,* 49 Yale L.J. 1401 (1940).

More than half of the Penn Central system was leased from some 40-odd lessor companies. Fifteen of these lessors are also in bankruptcy, as Secondary Debtors in these proceedings. In the case of these 15 Secondary

Debtors, Penn Central itself owns most of the stock and in some cases a portion of the outstanding debt. During the course of the proceedings, the Trustees neither adopted nor rejected the leases. Nor is there provision in the Plan for the adoption or rejection of the leases. Rather, the Plan takes the relatively simple and straightforward approach of cancelling out the mutual claims of the lessor and lessee companies, distributing to the public holders of bonds of the lessor companies the security package which is distributed to the public holders of Penn Central bonds, and quantifying the value of the dividend income to the public shareholders and with respect to the value of the stock, treating them as secured creditors. Satisfaction of the debt and equity holders of the Secondary Debtors and consummation of their respective Plans will result in the reorganized company having effective control of the reorganized Secondary Debtors. The Plan assumes this result and also assumes the assets of the Secondary Debtors will be available to the reorganized company to service its securities.

In effect, the R & I Indenture Trustee contends that for the purposes of the retained asset analysis the R & I Mortgage has a claim to the retained assets of the Michigan Central Railroad Company (MC) and Cleveland, Cincinnati, Chicago & St. Louis Railroad Company (Big Four), which preempts the claims of the public debt and equity holders of those two Secondary Debtor lessors.

This claim arises because, as to both of these railroads, stock owned by Penn Central, is pledged to the R & I Indenture Trustee as security for the R & I Mortgage. Article 7, § 9 of the R & I Mortgage provides that if the mortgagor has pledged the majority of the stock of another company under the R & I Mortgage, and if the mortgagor thereafter acquires any "indebtedness, lien, or charge" by

or against said company, the mortgagor shall, at the request of the R & I Indenture Trustee, assign such indebtedness, lien or charge to the R & I Indenture Trustee. Ninety-nine percent of the MC common and 97% of the Big Four common and 84% of the Big Four preferred shares are pledged under the R & I Mortgage.[66] The R & I Indenture Trustee contends that operations over the MC's lines during reorganization produced operating losses of $104.5 million, and that operations over the Big Four lines during reorganization produced operating losses of $84.4 million. If both leases were rejected in the Plan, the Penn Central estate would be entitled to "charge back" those amounts against the lessors; this charge-back would be an "indebtedness, lien or charge" within the meaning of the after-acquired property clause referred to above, assignable to the R & I Indenture Trustee; hence, the R & I's retained asset security should be increased.

If this argument is accepted in its entirety, the effect would be approximately as follows: All of the retained assets of MC ($41 million) and of the Big Four ($79.95 million) would be added to the retained-asset security of the R & I Mortgage.[67] In that event, the $27.8 million value assigned to MC stock pledged under the R & I Mortgage would be eliminated from the security of the mortgage. The net increase in retained assets of the R & I Mortgage would be $93.081 million, its retained asset coverage would increase from 29.7%[68] to 62.8%,[69] and the

66. The Michigan Central Collateral Indenture has the first lien on 168,143 shares of the MC common. However, the value attributable to these shares is marshalled down to the R & I Mortgage. Another 17,848 shares are pledged under the R & I Mortgage. The value attributable to the total shares is $27.8 million. No value is attributable to the Big Four stock because the Big Four's outstanding public debt exceeds the amount of its retained assets.

67. Volume II, 122, 151.

68. See page A262.

69. See page A263.

68. Collateral Trust Bonds—015 Mortgage

Mtg. #	Description		Net Claim	Claim on 015 Assets	Under-lying Security	Versus Net Claim: Deficiency	Versus Net Claim: Excess	Distri-bution of Excess	Total Distri-bution
CTB	PC 6½	1993	$ 140	$ 4,185	$ 1,226		$1,086		$ 140
CTB	NYC 6	1980	26,967	53,043	15,542	$ 11,425		$ 113	15,655
CTB	NYC 5¼	1980	248	903	265		17		248
CTB	NYC 5⅜	1980	685	1,843	540	145		3	543
CTB	NYC 6	1990	1,117	3,900	1,143		26		1,117
CTN	NYC 5	1974	14,012	29,199	8,555	5,457		59	8,614
109	CR&I		13,001	26,100	7,647	5,354		55	7,702
	Total		56,170	119,173	34,917	22,381	1,129	230	34,019
015—1	R&I A	2013	125,689	125,689	36,827	88,862		528	37,355
015—3	R&I C	2013	89,119	89,119	26,112	63,007		374	26,486
	Total 015 Bonds		214,808†	214,808	62,939	151,869		902	63,841†
	Grand Total		$270,978	$333,981	97,856*	174,250	1,129	1,132*	97,860*

STEP 1. To allocate retained assets first determine the percentage that total retained assets are of all claims on 015 assets ($97,801/$333,981 = 29.3%). The amount of 015 assets available to satisfy a claim is computed by multiplying the claim by the percentage. (*E.g.*, NYC 6s of 1980: 29.3% of $53,043 equals $15,542 available).

STEP 2. To allocate the excess of 015 assets first determine the net claim unsatisfied by subtracting from the total net claim the net claim of collateral indentures which have excess 015 assets ($270,978 — $1,505 = $269,473). Divide the excess by the net claim unsatisfied to give the percentage excess assets are of the net claim unsatisfied ($1,146/$269,473 = .42%), and multiply each unsatisfied claim by that percentage.

† Retained asset coverage of public holders of R & I bonds; $63,841/$214,808 = 29.7%.

* Discrepancy due to rounding.

69. Collateral Trust Bonds—015 Mortgage

Mtg. #	Description		Net Claim	Claim on 015 Assets	Under-lying Security	Underlying Security Versus Net Claim: Deficiency	Underlying Security Versus Net Claim: Excess	Distri-bution of Excess	Total Distri-bution
CTB	PC 6½	1993	$ 140	$ 4,185	$ 2,394		$ 2,254		$ 140
CTB	NYC 6	1980	26,967	53,043	30,340		3,373		26,967
CTB	NYC 5¼	1980	248	903	516		268		248
CTB	NYC 5⅜	1980	685	1,843	1,054		369		685
CTB	NYC 6	1990	1,117	3,900	2,231		1,114		1,117
CTN	NYC 5	1974	14,012	29,199	16,702		2,690		14,012
109	CR&I		13,001	26,100	14,929		1,928		13,001
	Total	015	56,170	119,173	68,166		11,996		56,170
015—1	R&I A	2013	125,689	125,689	71,894	$53,795		7,038	78,932
015—3	R&I C	2013	89,119	89,119	50,976	38,143		4,958	55,934
	Total 015 Bonds		214,808†	214,808	122,870	91,938		11,996	134,866†
	Grand Total		$270,978	$333,981	191,036	91,938	11,996	11,996	191,036

STEP 1. To allocate retained assets first determine the percentage that total retained assets are of all claims on 015 assets ($191,081/$333,981 =57.2%). The amount of 015 assets available to satisfy a claim is computed by multiplying the claim by the percentage. (*E.g.*, NYC 6s of 1980: 57.2% of $53,043 equals $30,340 available).

STEP 2. To allocate the excess of 015 assets first determine the net claim unsatisfied by subtracting from the total net claim the net claim of collateral indentures which have excess 015 assets ($270,978 — $56,170 = $214,808). Divide the excess by the net claim unsatisfied to give the percentage excess assets are of the net claim unsatisfied ($11,996/$214,808 = 5.6%), and multiply each unsatisfied claim by that percentage.

† Retained asset coverage of public holders of R & I bonds: $134,914/$214,088 = 62.8%.

A bond distribution would be increased from $19.1 million to $40.4 million. There would be no A bond distribution to the Big Four bondholders, and the 100% cash distribution to the MC bondholders would have to be reconsidered and no doubt adjusted.

I have concluded that the position asserted by the R & I Indenture Trustee is untenable, and that its arguments must be rejected, because even if chargeback claims for operating losses could be established and quantified, they would not be within the ambit of the after-acquired property clause of the R & I Mortgage.

In the first place, any such chargeback claim would belong to the Trustees of the Penn Central estate, and not to the Penn Central as mortgagor under the R & I Mortgage. While it is not often necessary to engage in fine distinctions between prebankruptcy Penn Central, as a "successor corporation" to the original mortgagor (Article 6, § 2 of the R & I Mortgage), Penn Central as a Debtor under § 77 of the Bankruptcy Act, and the Trustees of the Penn Central, the distinctions are real enough.[70] And in these circumstances, it is particularly necessary to observe them. If there were operating losses on the MC and Big Four lines, giving rise to chargeback claims, they were made possible because the operations were sustained by cash generated by the Penn Central estate as a whole. To say that this detriment suffered by the estate as a unit should now be redressed, but only for the benefit of the R & I Mortgage, is to express a strange view of the appropriate exercise of the equitable powers of a federal court.

Second, the true intent of the parties to the R & I Mortgage Indenture would be frustrated if such chargeback claims were picked up by the after-acquired property clause. The mortgage instrument was carefully drafted in order to make clear that it was not intended to prime or displace existing mortgages of the MC and Big Four. Chargeback claims do prime the existing mortgages, and to include such claims within the lien of the R & I Mortgage would produce a result plainly not contemplated by the parties. Moreover, it would be anomalous indeed, where stock is pledged as collateral for a loan, for the lender's security to increase as the direct result of the unprofitability of the corporation whose stock is pledged.

I am satisfied that the essential purpose of the after-acquired property clause in the R & I Indenture was to insure that the mortgagor, which was in a position to control the MC and Big Four, would not be able to dilute the value of the pledged stock by creating additional debt obligations, and that any acquisition by the mortgagor of existing debt obligations of MC or the Big Four would inure to the benefit of the R & I Mortgage. Consistently with this interpretation, if in their retained asset analysis, the Trustees reduced the value of the pledged MC and Big Four stock because of the existence of actual or potential chargeback claims for operating losses, the R & I Indenture Trustee would have valid grounds to assert that to the extent the chargeback claim reduced the value of the pledged stock the after-acquired property clause should be interpreted as applying to the chargeback claim. But that has not been attempted here; the Trustees' analysis accords full value to the pledged collateral.

What has been stated thus far serves to dispose of the contention that the R & I Mortgage should be credited with a greater amount of retained assets because of possible chargeback claims available to the Trustees. But the conclusion that potential chargeback claims are not within the

70. *Cf. In re Sequential Information Systems*, Transfer Binder, CCH Sec. Trans. Guide ¶ 51479, in which Bankruptcy Judge Herzog held that inventory acquired by a Chapter XI debtor in possession was not subject to a valid lien on the debtor's inventory, despite its "after-acquired" features.

reach of the R & I Mortgage does not automatically mean that such claims should not be asserted by the Trustees; the propriety of the compromise disposition of these claims by mutual cancellation is an issue which should be addressed at this time because, regardless of its impact upon the retained asset security of the R & I Mortgage, the nonassertion of chargeback claims against lessors does have an impact upon the structure of the Plan and its proposed distributions. Moreover, in view of the arguments presented, I believe it is helpful to assess the strengths and weaknesses of the potential chargeback claims because, in my view, the proposed compromise cancellation of such claims is eminently fair and reasonable, and should be approved over the objections of the R & I Indenture Trustee even if such claims were within the reach of the after-acquired property clause of the R & I Mortgage.

The task of actually establishing the existence and amount of operating losses over the MC and Big Four lines would be formidable indeed. The Penn Central system was operated as a single unit. In order to determine the operating results over a particular segment of the system, segregation studies must be relied upon; and segregation studies are necessarily inexact, and subject to legitimate controversy. The segregation studies prepared by the Trustees' consultants for the years 1972 and 1973,[71] upon which the R & I Indenture Trustee's projected operating loss figures are based, are no exception. For example, the study attributes revenues to the MC and Big Four lines on a "normal route" basis (it apparently being now impossible to establish the actual routings); and expenses were allocated to these lines on the basis of system-wide unit costs. Because of the Trustees' proposal that mutual debt be cancelled, this particular segregation study has not, of course, been the subject of an adversarial examination by the MC and Big Four Trustees. An earlier segregation study employing the same methodology (in connection with the § 207(b) hearings) was sharply challenged by expert witnesses testifying on behalf of the MC and Big Four Trustees.[72]

In the case of the Big Four particularly, relatively slight adjustments in either the revenue or expense allocations made in the segregation study would produce a very different result. The study itself shows 1972 losses on the Big Four as only 7.8% of revenues, and 1973 losses as only 3.5% of revenues. It is not without significance that notwithstanding the similar results of the earlier segregation study, this Court concluded, in connection with the § 207(b) proceedings, that the Big Four had not been shown to be incapable of independent reorganization. *See In re Penn Central Transp. Co. (Proceedings pursuant to § 207(b) of the RRRA)*, 382 F. Supp. 821 (E.D. Pa. 1974); and *In re Penn Central Transp. Co.*, 382 F. Supp. 851 (E.D. Pa. 1974).

It should also be noted that the R & I Indenture Trustee's assumption that the average of the 1972 and 1973 operating results can safely be projected to the other years involved may or may not be valid, and would no doubt be challenged by parties opposed to an attempted chargeback.

More fundamentally, there are serious questions as to whether the chargeback doctrine of *Palmer v. Palmer*, and *Warren v. Palmer*, can be applied at all in the unique con-

71. Affidavit of Edward R. Jennison, Volume I, 33.

72. Affidavit of Mr. Simat, Doc. No. 7432, and affidavit of Mr. Seibert, Doc. No. 70 in No. 70-347-H. While there are technical differences between the two segregation studies and the studies were made for different purposes, the affidavits in the § 207(b) proceedings are relevant for the limited purpose of pointing up the possible issues that would arise in litigation over the existence and amount of any chargeback claim.

text of this case. It is arguable, for example, that the mandated conveyance to ConRail, which has rendered it impossible for either the lessor or the lessee to operate over the lines, simply terminated the leases at that point, and that the Trustees are precluded from exercising their normal right or rejection of the lease. Assuming the power to reject remains unimpaired, it can be argued that any chargeback claim should be satisfied, at least in substantial measure, out of the proceeds of the Valuation Case; the issues here parallel those involved in the state and local tax claims (Section II F *supra*).

And finally, lessors faced with chargeback claims would undoubtedly attempt to establish that operating losses would not have been sustained, or would have been greatly reduced, if Penn Central's operating decisions had not resulted in "diversion" of traffic from their respective leased lines. The complexities of the Penn Central rail network render it more than usually susceptible to such challenges. And there is the further complicating factor that (for reasons of economy primarily) independent Trustees for the bankrupt lessors were not appointed until after the RRRA was enacted.[73] Thus, during most of the relevant period, Penn Central and its Trustees occupied a position vis-a-vis the bankrupt lessors that can be regarded as involving fiduciary responsibilities which, though not altogether precluding lease rejection and chargeback, would at least call for very close scrutiny of their stewardship leased line operations.

ii. The Harlem Leasehold

All of the property of the New York & Harlem Railroad Company is leased to the Debtor; the lease expires in

73. The history of the Secondary Debtors' proceedings is outlined briefly in *Penn Central Transp. Co. (Proceeding Pursuant to* § 207(b) of the RRRA), 382 F. Supp. 821 (E.D. Pa. 1974).

the year 2274. The Debtor owns 95% of the stock of the Harlem, which owes $10.25 million on publicly held debt.[74] Penn Central's leasehold interest is subject to the lien of the Gold Bond Mortgage, the Consolidation, and the R & I Mortgage, in that order. Penn Central's stock interest in the Harlem is pledged as collateral under the R & I Mortgage.

The problem addressed by the Trustees in their analysis underlying the distributions proposed in the Plan is the proper allocation of the Harlem's retained asset values as among the various interests. The correct conceptual approach to this problem is not self-evident. As a general proposition, it can be said that the value of Penn Central's leasehold is the aggregate value of the properties (after deducting a relatively nominal sum as the value of the reversion), less the present value of Penn Central's obligations under the lease. It can also be said that the interest of the Harlem (and hence, for present purposes, the value of the Harlem stock) consists of a relatively nominal sum representing the reversionary interest, plus the present value of the payments to be made under the lease. There are at least two sets of complications encountered in making allocations of retained assets to the various mortgages by applying this general approach to valuation. The Penn Central's obligations under the lease cover not only a set amount per share of Harlem stock, but also amortization of Harlem's publicly held debt. And there is the question whether the calculation should assume that Penn Central would be paying the required dividends on the Harlem stock owned by Penn Central. Different answers to the latter question might be appropriate, depending upon whether one is considering Penn Central's obligations to

74. The Harlem lease is discussed in detail in *In re Penn Central Transp. Co. (Sale of Park Avenue Properties)*, 354 F. Supp. 717 (E.D. Pa. 1972); *In re Penn Central Transp. Co.*, 354 F. Supp. 759 (E.D. Pa. 1972).

the Harlem as lessor, or its obligations to the R & I mortgagee as pledgee of the Harlem stock.

In formulating the Plan, the Trustees initially adopted the principle that no value should be assigned to leasehold interests. Thus, the Plan as originally proposed did not credit any of the Harlem's retained assets to the 013-015 mortgage chain. Instead, these retained asset values were allocated first to the publicly held debt of the Harlem, \$10.25 million, and certain intercompany obligations of the Harlem, \$.38 million. The balance of the retained asset values, \$81.21 million, was then credited to the outstanding stock of the Harlem. Approximately \$4 million was assigned to the publicly held stock, and since almost all of the remaining outstanding stock held by Penn Central is pledged under the R & I Mortgage, \$77.2 million was credited to the R & I Mortgage.

In light of objections presented at the hearings to this treatment, however, the Trustees amended the Plan by crediting \$29 million to the 013-015 mortgage chain.[75] This was the amount necessary to render both the Gold Bond and Consolidation Mortgages fully secured by retained assets. The Trustees concluded that since the leasehold was worth at least \$29 million, there was no need to do a complete valuation of the Harlem leasehold to determine its exact value.

The amended treatment of the Harlem's retained assets reduced the retained assets available for the Harlem's equity, and as a result the value of the Harlem stock pledged under the R & I Mortgage was reduced by \$29 million to \$48.2 million.

In summary, the Trustees have allocated \$10.25 million to the publicly held debt of the Harlem, \$29 million to the 013-015 mortgage chain, and \$48.2 million to the R & I Mortgage.

75. Trustees' Brief, pp. 190-98.

If the Harlem's publicly held debt has first call on the Harlem's retained assets, increasing the amount allocated to the leasehold does not benefit the R & I Mortgage. The Gold Bond and Consolidation Mortgages are both fully secured by retained assets and, therefore, an increase in the amount assigned to the leasehold would simply be marshalled down to the R & I Mortgage.

The R & I Indenture Trustee argues that under a proper analysis of the value of the leasehold interest, none of the Harlem's retained assets would be allocated to the Harlem's public debt. Of course, if this is correct, the \$10.25 million would eventually reach the R & I Mortgage in one way or another. Quite correctly, the R & I Indenture Trustee argues that if the leasehold interest were actually valued, the retained assets would be allocated between the Trustees' leasehold interest and the Harlem's reversionary interest, and the public debt of the Harlem would have a claim against only the retained assets allocated to the reversion. It is also correctly asserted that since the Harlem lease was affirmed during the course of the proceedings and is not rejected in the Plan, the reorganized company is obligated to comply with the Harlem lease, and that includes servicing the publicly held debt and stock of the Harlem. It does not follow, however, that the full amount of the Harlem's retained assets should be allocated to the leasehold interest.

It is clear that the maximum value of the leasehold is the value of the retained assets less the cost of performing the leases. All agree that the cost of maintaining the lease is at least \$624,000 per year (interest on publicly held debt plus stock dividends). Assuming a 6% yield rate on investment, the present value of the cost of paying \$624,000 per annum over the next century is \$10.4 million. If the intercompany obligations are also properly charged against

the leasehold value, the combined deduction of lease maintenance and intercompany obligations is $10.76 million, which is substantially equivalent to the $10.6 million deduction for public debt and intercompany obligations embodied in the Trustees' analysis.

Moreover, the Trustees have asserted that there are additional lease maintenance costs: $700,000 arising from the Trustees' arrangements with the Metropolitan Transportation Authority covering certain of the Harlem's properties and $.5 million in taxes. Neither suggestion is clearly spelled out in the record, and the taxes would presumably have been already netted out in a rough way in the Asset Disposition Program analysis which generated the total asset values. If these two items later become relevant, they can be clarified further.

In any event, it is clear that the R & I Mortgage comes out basically the same under the Trustees' approach or under the Alternative method of valuing the costs of the lease. Therefore, no change in the Trustees amended allocations of the Harlem's retained assets is warranted.

The method of handling the Harlem leasehold also affects the Gold Bond and Consolidated Mortgages. If more than $29 million were allocated to the leasehold, the Gold Bond retained asset coverage would increase accordingly. For the reasons stated in Section II-G-2, for the purposes of the so-called super secured argument, the Lake Shore and Michigan Central Collaterals would not benefit from the additional amounts credited to the 013 Gold Bond Mortgage. In connection with the Detroit Bank's liquidation and cash flow scenario arguments, the discussion took account of the possibility that an upward adjustment might be appropriate. Thus, while theoretical problems do exist concerning the "right way" to treat the Trustees' Harlem leasehold interest, in the context of the Plan the proposed allocation is satisfactory.

iii. Rents From the Park Avenue Properties;
Dividends on the Harlem Stock

Under the terms of the Harlem lease, Penn Central is required to pay, as rent, $5 per share annually to the holders of Harlem stock. However, the third supplemental contract of the Harlem lease provides that this per share rental need not be paid on these shares of Harlem stock owned by Penn Central itself, unless such payment is required in order to comply with the terms of the R & I Mortgage (Penn Central's Harlem shares being pledged as security under that mortgage). The R & I Mortgage Indenture provides that, in the event of default, the Indenture Trustee is entitled to receive the dividends on the Harlem stock and apply them to the mortgage debt.

In approving the Trustees' decision to affirm the Harlem lease, this Court held, over objection by the R & I Indenture Trustee, that the dividends on the pledged stock need not be paid as a condition of affirmance. *In re Penn Central Transp. Co. (Sale of Park Avenue Properties)*, 354 F. Supp. 717, 736-37 (E.D. Pa. 1972), *aff'd in part and rev'd in part*, 484 F.2d 323 (3d Cir.), *cert. denied*, 414 U.S. 1079, 94 S. Ct. 598, 38 L. Ed. 2d 485 (1973). I left open the question of how this suspension of the mortgagee's right to receive dividends should be treated in the Plan of Reorganization. The unpaid dividend-rental on the pledged Harlem stock to date amounts to approximately $7.1 million.

The properties covered by the Harlem lease have generated rental income to the Debtor's estate in the amount of approximately $70 million. The R & I Indenture Trustee earlier sought to have these rents sequestered, but this request, too, was rejected, 354 F. Supp. at 741. Thus, as a result of this Court's earlier decisions, funds which on default the R & I Indenture Trustee was entitled to claim

as additional security for the R & I Mortgage were expended by the Trustees to support current operations.

The R & I Indenture Trustee now argues that both the $7.1 million in unpaid dividends and the $76 million in rent diversions should be added to the retained asset coverage of the R & I Mortgage, for purposes of determining the A-B bond distributions. The principal contention made is that, as a matter of bankruptcy law, and as a matter of constitutional doctrine, use of pledged income for the payment of operating expenses constitutes an impairment of security which must be rectified by restoring to the secured creditor an amount equal to the pledged funds used. However that may be, since the R & I Mortgage is being treated in the Plan as fully secured, the problem of possible impairment of security does not arise.

The issues addressed by the argument of the R & I Indenture Trustee generally arise at either of two levels: First, whether it is legally permissible to use liened assets, or the income generated thereby, to meet expenses of current operations; and second, where impairment of security does occur, whether it is necessary in the Plan to accord to the affected creditor an administration claim or other high-priority claim in the amount of the impairment. *See generally* Countryman, *Treatment of Secured Claims in Chapter Cases,* 1977 Comm. L.J. 349 (1977). In the present case, however, this Court and the Court of Appeals approved the use of the money for operating expenses, so the first issue is behind us; and the Plan treats the R & I Mortgage as fully secured, so the problem of restoration does not arise.

What is involved here is a much narrower issue, namely, what kinds of securities should be used to discharge this admittedly fully secured claim. The answer to that question depends not upon theories brought into play

by past happenings, but upon the nature of the assets actually securing the claim. The issuance of a greater or lesser amount of A bonds under the Plan reflects a greater or lesser proportion, in the assets securing the particular claim, of assets which can be liquidated or otherwise realized upon in the near future. Obviously, the rents and dividends previously spent by the Trustees to support rail operations, or even the hypothetical right to restoration of these funds, are not the kinds of assets which would justify the issuance of A bonds.

Indeed, the same conclusion would follow even if the R & I Mortgage were not treated as fully secured, and even if the controversial issue of security restoration were then resolved in favor of the R & I position. That is, the fact that part of the security for the R & I Mortgage would then consist of a high-priority right to have the previously spent cash replaced would not necessarily justify or require the issuance of liquidity-oriented securities in payment. To say that cash should be restored as security for a mortgage does not automatically produce the cash. The true consequence of any such restoration decree would be to ensure that the full amount of the mortgagee's claim would have to be dealt with before junior lienholders could participate, and not to mandate the issuance of a particular kind of security. The nature of the securities to be used in payment of the claim secured by the "restored" assets would depend upon whether, as a result of marshalling, the actual assets assignable to the restoration were, or were not, relatively liquid.

Perhaps another way of expressing the reasons for rejecting the arguments of the R & I Indenture Trustee is to point out that, even assuming it were necessary to replace the previously expended rents and dividends in order to secure the R & I Mortgage in full, and even assuming that the mortgagee would have a constitutional right to

such restoration, it would not necessarily be inappropriate to "trace" the expended funds to the rail operations which received them, and to look to railroad assets for their replacement. In the present context, of course, "the railroad" means essentially the proceeds of the Valuation Case, represented by B bonds, not A bonds.

A final point to be dealt with is the assertion that the Plan's allocations of A and B bonds are unfair because, in instances where mortgaged property was sold during reorganization, those mortgages are credited with retained asset security in amounts which include the accumulated interest on the deposited sale proceeds, whereas the rentals earned by properties which have not been sold are not so credited to the respective mortgages. There is a surface appeal to this argument; if particular properties had not been sold, presumably the rent received from those properties would also have been expended in the course of the reorganization, and would not now be available to support a greater allocation of A bonds. By the same token, if some of the retained properties had been sold, and the proceeds deposited, the accumulated interest on those deposits would now be available for credit to the retained asset security of the mortgages.

Upon further analysis, however, I am persuaded that the approach adopted by the Trustees in the Plan is fair and reasonable. In the first place, all mortgages are treated alike in this respect. Rental income which has been spent and is not now available is not included in the retained asset allocations, whereas accumulated interest on sale proceeds, which is available, is so credited. This pragmatic approach clearly reflects the realities of the situation. There is no discrimination between mortgages. Any differential impact is attributable to earlier decisions by the Trustees, made in good faith and acquiesced in by all parties, that it was in the best interests of the estate

to sell certain properties while retaining others. There is ample precedent for the proposition that rental income during reorganization is properly treated like any other income from operations. *In re Philadelphia & Reading Coal & Iron Co.*, 117 F.2d 976 (3d Cir. 1941).

More fundamentally, we are dealing here with the present market value of the assets securing the mortgages. The present market value of retained real estate is based in large part upon capitalization of its earning power, but most assuredly does not include the amount of rentals heretofore produced, as such. If the properties had been sold earlier, in all probability the sale price would have been lower than the present market value. The present value of the escrowed proceeds, on the other hand, does properly include the accumulated interest on the deposits. Sales of particular properties have been made pursuant to a business judgment that the sale was advantageous to the estate, that is, that the sale would preserve values which might otherwise be lost, either through excessive maintenance costs, threatened decline in market value, or similar considerations. Comparison between the net income produced by the real estate, and the interest which could be earned by the proceeds, was a key ingredient of these business judgments. In a very real sense, therefore, the escrowed proceeds, including accrued interest, stand in substitution for what otherwise would be the present market value of the real estate. I do not believe that the R & I Indenture Trustee, or any other secured creditor, can justly complain because, in appropriate instances, the value of assets was preserved through sale.

iv. Interest on Beech Creek, Harlem and Big Four Bonds

The Trustees' retained asset analysis credits to the R & I Mortgage \$.5 million in principal amount of matured

but uncancelled second mortgage bonds of the Beech Creek Railroad. It appears to be conceded that, under New York law, matured bonds continue to bear interest at the legal rate, and that under the terms of the R & I Mortgage, interest on deposited bonds accrues to the benefit of the mortgage. The Trustees now concede, further, that pursuant to Article 7, § 9 of the R & I Mortgage Indenture, \$3.839 million (principal) in bonds of the Big Four and \$.78 million (principal) in bonds of the New York & Harlem Railroad Company are subject to the lien of the R & I Mortgage and should be added to the R & I retained asset credit. The R & I Indenture Trustee complains because the accrued interest on these bonds has not been included in the retained assets assigned to the R & I Mortgage.

As explained in Document J-3 in the Reorganization Library, the Trustees' analysis disregards bonds held by Penn Central, unless they are pledged as collateral security. Of course, bonds held by others than Penn Central are calculated at their face amount plus accrued interest. In the case of pledged bonds owned by Penn Central, accrued interest is omitted. There is no unfairness in this approach, so long as all pledges (*i.e.*, mortgages and collateral trusts) are treated uniformly in this regard. As it happens, application of a uniform policy of including interest on pledged bonds would actually reduce the A bonds distributed to the public holders of R & I bonds, because of the large amount of Penn Central-owned R & I bonds which are pledged as collateral under other mortgages. Section II-G-3-d. There is no merit in this objection.

v. Pre-bankruptcy Sales

Because of the lengthy terms of railroad mortgages and the business necessities of railroad operations, railroad mortgages usually contain provisions permitting the rail-

road to dispose of portions of the mortgaged property no longer needed for rail service, so long as the mortgage security is not thereby impaired. So long as the purchase price is reasonable, the railroad can generally require the mortgagee to release a particular property from the lien of the mortgage either by depositing the net sale proceeds with the mortgagee as security, or, as is more generally the case, by satisfying the mortgagee (through certification) that "additions and betterments" have been made to the mortgaged property which are of equal or greater value than the sale proceeds.

Over the years, Penn Central and many of its indenture trustees were less than punctilious in carrying out the formal requirements of such transactions. Penn Central would sell property and obtain the sale proceeds on the strength of a letter stating that releases from the mortgage would be forthcoming, and agreeing to indemnify the purchaser and/or title insurance company against loss by reason of the lien of the blanket mortgage. Days, weeks, or even months later, the necessary documentation of additions and betterments would be furnished to the indenture trustee, and the required release of mortgage would be executed and delivered. Since everyone concerned was fully aware, at least in most cases, that Penn Central was entitled to credits for additions and betterments vastly in excess of the sale proceeds, it is perhaps understandable that a certain amount of laxity crept into the proceedings.

When the bankruptcy petition was filed, it developed that Penn Central had made various sales before bankruptcy, for prices aggregating some \$2.135 million, for which no releases of mortgage had yet been obtained. Penn Central had, of course, already spent the money. Many of the purchasers had already undertaken substan-

tial improvements on the purchased real estate, assuming they had clear title. When apprised of the situation, the Penn Central Trustees sought to obtain releases from the mortgages, but without success; the Indenture Trustees contended that the mortgage default represented by the filing of the bankruptcy petition terminated their obligation to recognize additions and betterments.

One of the purchasers, the New York Urban Development Corporation, which had undertaken a large-scale housing project on the parcel it purchased from Penn Central, petitioned this Court for relief. On the basis of a finding that pre-bankruptcy additions and betterments greatly in excess of the sale price had been made to the mortgaged property as a whole by Penn Central (including, for example, the "Selkirk Yard" costing in excess of $30 million), I entered as Order directing the Indenture Trustee to execute and deliver the required releases. *In re Penn Central Transp. Co.*, 346 F. Supp. 1323 (E.D. Pa. 1972). On appeal, however, this Order was vacated. The Court of Appeals held that the present value of the additions and betterments, rather than their original cost, was the appropriate standard, and that the evidence submitted at that particular hearing was not addressed to the present value issue, and was not sufficiently specific to support a possible alternative ruling based upon the invasion-of-security standards set forth in *Central R.R. of New Jersey v. Manufacturers Hanover Trust Co.*, 421 F.2d 604 (3d Cir. 1970). The matter was remanded to this Court. *In Penn Central Transp. Co.*, 468 F.2d 1222 (3d Cir. 1972). Since that time, individual problems have apparently been resolved as they may have arisen.

The Plan (Section 11.1) clears up this situation, confirming the purchasers' titles free and clear of the mortgages which should have been released before bankruptcy. The R & I Indenture Trustee now contends that its right

to proceed against the properties in the hands of the purchasers, which right has been frustrated, should be reflected in the "retained asset" coverage of the R & I Mortgage. Indeed, the assertion is made that the correct measure of the value of this security interest is not merely the sale price of the land sold, but the present market value of the land and all improvements thereon.

Many, probably most, of the properties have been greatly improved by their purchasers. For example, the New York Urban Development Corporation has invested some $13 million in improvements (Doc. No. 1500), and the City of Indianapolis has added about $20 million to its property (Doc. No. 10,616). The notion that any court, state or federal, would be likely to enforce the lien of the R & I Mortgage against these improvements appears farfetched.[76]

Since equitable principles must be applied in this proceeding, and undoubtedly would also be recognized in state court foreclosure proceedings, I am satisfied that the most that could be involved here is the net sale price, plus interest. If the analysis set forth in the Trustees' Reply Brief is correct, which it appears to be, the benefit which might accrue to the R & I Mortgage (after taking prior liens into account) would be about $.75 million, plus interest. Making the generous assumption that interest should be calculated at the rate of 8%, compounded annually, the potential credit to the R & I Mortgage would be approximately $1.31 million. Thus, the Trustees could perhaps remove this particular objection of the R & I Indenture Trustee by either crediting that additional amount to the R & I Mortgage retained assets, or by formalizing of record what is well known to al! of the parties, namely, that the actual present value of the additions and better-

76. *See* Glenn, *Mortgages* § 202 (1941).

ments to the mortgaged property, not previously reflected in the certifications pursuant to the betterment accounting under the mortgage, is in excess of that sum.

The reason the Court of Appeals vacated this Court's earlier Order requiring the Indenture Trustee to release the sold parcels from the lien of the mortgage was that the record did not then establish that the mortgagee's security would not thereby be impaired. Admittedly, Section 11.1 of the Plan now achieves the same result that this Court's earlier Order would have produced, but this is now perfectly proper, since the Plan treats the mortgage as fully secured. Thus, the Plan also supplies the key ingredient —non-impairment of security—absence of which flawed this Court's earlier Order.

It is unnecessary to reach a definitive conclusion concerning an alternative line of argument advanced by the Trustees, namely, that the A-B bond allocations reflect the nature of the assets available to the mortgages as security, and that there are no assets in the estate to support a greater allocation of A bonds.[77] It should be noted, however, that the cash received from these pre-bankruptcy sales was expended before bankruptcy, in support of rail operations. A post-bankruptcy obligation to replace that cash (*i.e.*, even assuming the value of additions and betterments could not be established) would not necessarily rank ahead of claims of other secured creditors.

77. The mortgagee's right, if any, to foreclose against the properties in the hands of their purchasers is not a claim against assets of the Debtor's estate. Presumably, if foreclosure were successfully pursued, the Penn Central estate would be liable to the purchasers or their title companies under the indemnification arrangements, but this might well be merely an unsecured general claim against the estate. Barring the exercise of the alleged foreclosure right aids the purchasers, but benefits the Debtor's estate only by protecting it against this indemnification claim. Preventing the assertion of that kind of claim does not free up any assets which can now be made available to the R & I Mortgage.

When all is said and done, however, the Plan does preclude the R & I Mortgagee from pursuing litigation against the purchasers which might have produced prompt cash settlements. That potential cash payment would have been as valuable to the mortgagee as a like amount of retained assets. I believe the fairest approach is to credit the R & I Mortgage with a further sum of $1.3 million in retained asset security.

vi. Lien Rights of Matured Bonds

There are deposited under the R & I Mortgage $16.3 million in matured and cancelled bonds of a number of smaller railroads which were refunded through the R & I Mortgage. The mortgage purports to preserve for the benefit of the R & I Mortgage the first lien of these bonds. The Trustees apparently concede the validity of the R & I Indenture Trustee's conclusion that the property subject to the liens of the refunded bonds should be credited to the R & I Mortgage as retained assets. In their own analysis $3.9 million of the $16.3 million in matured and cancelled bonds is credited to the R & I Mortgage. The remaining $12.4 million in cancelled bonds is credited to the prior lienholder, the 014 Consolidation Mortgages. Because the Consolidation Mortgage is over-secured by $25.195 million in retained assets, the R & I Mortgage will in no way benefit from having the $12.4 million credited to it because a countervailing reduction in the retained assets of the Consolidation Mortgage would be necessary and an equal amount would then be subtracted from the excess security which now passes down to the R & I Mortgage. In sum, no net change would result from acceptance of the R & I Indenture Trustee's theory.

b. Pennsylvania Railroad General Mortgage

The Trustees' leasehold interests in the United New Jersey Railroad & Canal Company, Philadelphia & Trenton

Railroad Company, Connecting Railway Company, and the Northern Central Railway Company are subject to the lien of the Pennsylvania Railroad General Mortgage of 1915 (the PRR General). (For convenience, the four companies owning these lease lines will be referred to as the Pennsylvania lessors.) Each of the Pennsylvania lessors is a Secondary Debtor in these proceedings and under the respective Plans the mutual debts of Penn Central and the Secondary Debtors are cancelled. Girard Bank, the Indenture Trustee of the PRR General, contends that the operations of each of the Pennsylvania lessors gave rise to chargeback or operating loss claims, and that under the after-acquired property clause of the PRR General these obligations of the Pennsylvania lessors are subject to the lien of the PRR General. In pertinent part, the PRR General provides:

> Rights and things, of every kind and description, now or hereinafter appurtenant to or used for in the operation of the said demised premises of railroad and canals, and all the corporate and other rights, including trackage rights, powers, privileges and franchises now owned or hereinafter acquired, connected with or relating to the use or operation of said demised lines of railroad and canals, [are subject to this mortgage].

Girard reads "all the corporate and other rights" to include all causes of action. In my view, however, this after-acquired property clause does not apply to the chargeback claims, if any, which the Trustees may have. While it may be that causes of action under the leases themselves would be subject to the PRR General Mortgage, the chargeback claims are akin to advances in the ordinary course of business. The money lent was not subject to

the PRR General's lien, and there is no reason why the obligation to repay should be subject to the lien. In any event, for the reasons stated in Section II-G-3-a-i, chargeback claims are not claims of the mortgagor under the PRR General Mortgage but are claims of the Trustees and, therefore, are not covered by the after-acquired property clause.

Girard also makes the related contention that the proposed mutual cancellation of debts between the Penn Central and the four Pennsylvania lessors is overly generous to the Secondary Debtors. The thrust of this argument is that there are substantial chargeback claims against the Pennsylvania lessors and that the Trustees failed to bargain adequately with the Pennsylvania lessors. Girard suggests that the Court substitute for the actual compromise proposed by the Trustees what Girard believes the results would have been in arms-length bargaining: allocation of 50% of the retained assets of the Pennsylvania lessors to the lessee, Penn Central. Girard, of course, assumes that the retained assets would then become available to the PRR General. There are a number of problems with this approach.

First, since the chargeback claims, the asserted bargaining weapons of the Trustees, are claims of the estate, the benefit of any compromise similar to that suggested by Girard would flow to the estate as a whole. Second, but more importantly, there is no basis the Court is aware of for concluding that the proposed settlement is not the combined product of arms-length bargaining and the Trustees' best business judgment. Throughout these proceedings, and in particular in connection with the Plan, the Secondary Debtor Trustees and the Penn Central Trustees have represented their respective interests vigorously and have conducted their litigation and negotiations as adversaries.

Moreover, I have considered the same questions, although in a somewhat different context, in connection with the Michigan Central Collateral Trust Indenture, Section II-G-3-a-i, and have concluded that the mutual cancellation of claims between Penn Central and the Secondary Debtors is fair and equitable. Girard has presented nothing which undermines that conclusion.

Finally, we should not overlook the fact that in most instances the Secondary Debtors are releasing very substantial portions of their retained assets for use for other purposes in the Plan. The four Pennsylvania lessors, for example, are releasing $36.238 million in retained assets in excess of the cash and A bonds distributed to their respective claimants under the Plan.

Girard's final contention also implicates the after-acquired property clause, which subjects to the lien of the PRR mortgage branches of and extensions to the mortgaged rail properties, as well as those originally mortgaged. When the PRR General Mortgage was created in 1915, the PRR owned controlling stock interests in three independently constructed and operated railroads which connected with the PRR's main line. This stock, however, was not subjected to the lien of the PRR General. Later, the three companies were merged into the Pennsylvania. The question is simply whether the merger of the three lines constitutes an acquisition of branches for the purpose of the after-acquired property clause. It is apparent that if these lines had been built by the Pennsylvania, they would be covered by the after-acquired property clause. The Trustees argue that the mortgage is ambiguous as to whether or not independently constructed rail lines such as those in question are within the scope of the mortgage, and that since after-acquired property clauses are to be construed narrowly, it follows that the clause does not

apply to these three lines. The failure of the parties to subject the PRR stock interests in the three lines to the lien of the mortgage tends to support this interpretation. On the other hand, if the parties had intended that the lines should never be security for the PRR General, it would have been simple enough to exclude them.

In re Wisconsin Central Ry., 68 F. Supp. 320 (D. Minn. 1946), relied on by both sides, provides an interesting contrast to the present situation. There the after-acquired property clause was similar to that of the PRR General, but the mortgage also provided

> . . . that nothing in this indenture contained shall be construed to limit the right or power of the Railway Company, hereby expressly reserved, to own and hold, or in any manner except by use of bonds secured by this indenture, to acquire by construction, purchase, or lease, other lines of railway, branches, or extensions, or equipment or interest therein, or new or additional terminals, and to hold and to dispose of any property so acquired, and to retain the proceeds thereof free from the lien of this indenture.

Id. at 326. The railroad later acquired an independently constructed rail line which connected with the mortgaged lines. The Court reconciled the above-quoted limitation with the after-acquired property clause by holding that since the independently constructed line was not a branch before acquisition it was not a branch for the purposes of the after-acquired property clause. The PRR General does not contain a comparable limitation. Failure to subject the stock interests to the mortgage, while a relevant fact, is not the equivalent of a specific limitation.

The nub of the issue then comes down to whether or not the clause is ambiguous. Its ambiguity, if any, lies in

the failure to specify whether the word "acquire" includes acquisition by merger. "Acquire" is a broad term which in the absence of limiting language, should be given a meaning most consistent with the terms of the mortgage as a whole. I am satisfied that the three lines in question were operated as branches after their acquisition through merger, and that since they were acquired by merger after the creation of the PRR General, the branches are within the scope of the after-acquired clause.

c. Michigan Central Collateral Indenture Claim to Michigan Central Assets

Of the Michigan Central's 187,380 outstanding shares of stock, Penn Central owns 187,146, of which 168,143 shares are pledged under the Michigan Central Collateral Indenture. Article 3, § 5 of that Indenture provides that upon consolidation, merger with, or sale of Michigan Central to, the Debtor or its successor, the lien of the Collateral Indenture attaches to the Michigan Central's physical assets. The Collateral Indenture Trustee argues that this provision became effective upon the conveyance of Michigan Central's properties to ConRail, or will become effective upon consummation of the Plans of Reorganization. I reject both contentions.

Preliminarily, it may be observed that even if the arguments were accepted, the benefit to the Collateral Indenture would be negligible. The result of treating the Collateral Indenture as constituting a lien upon the physical assets of the Michigan Central would be to increase the retained asset coverage from 115% to 125%, thus rendering it slightly more "super secured" than it already is.[78]

78. Under the Plan the pledged Michigan Central stock is valued at $25.195 million. If Article 3, § 5 of the Michigan Central Collateral Indenture created a lien on the Michigan Central property, that lien would be subordinate to the outstanding debt. The amount of retained assets remaining after satisfaction of the outstanding debt is $28.076 million. Of this amount, $21.856 million, the amount of the claim of the Michigan Central Collateral Indenture, would be allocated to the Michigan Central Collateral Indenture. The balance, $6.2 million, would be assigned to equity, and the stock pledged under the Michigan Central Collateral Indenture would be valued at $33.11 per share, $5.567 million for all the pledged stock. The combined retained assets available to the Michigan Central Collateral Indenture would be $27.43 million, a retained asset coverage of 125%.

But this would have no effect on the treatment of the Collateral Indenture under the Plan.

It seems obvious, however, that ConRail is in no sense a successor of the Debtor, as that term is used in the Collateral Indenture. And the Plan clearly does not achieve a consolidation or merger, as those terms are used in the Indenture. Under the Plan, both Penn Central and Michigan Central emerge as reorganized companies. Moreover, consummation of the Penn Central Plan would discharge the lien of the Collateral Indenture on the Michigan Central stock, and all other claims under the Indenture. In short, there is simply no basis for concluding that the provisions of Article 3, § 5 of the Collateral Indenture became operative upon the conveyance to ConRail, or would be triggered by consummation of the Plans.

d. New York Central 6% Collateral Trust Bonds Due 1980

The allocation of retained assets to secured obligations, for purposes of the A-B bond distribution, is complicated by the fact that the methods of financing employed by Penn Central and its predecessors seldom involved wiping the slate clean, discharging existing obligations, and starting afresh. The result is that, at the present time, Penn Central is the owner of a great many of the bonds which it is obligated to pay, and most of these are pledged as collateral security for other obligations of Penn Central.

78. (Cont'd.)

In the typical case, the mortgage provides that Penn Central is not required to pay interest on the bonds which it holds unless such payment is mandated under the pledge indenture. And the collateral trust indentures or other pledge documents generally provide that a default triggers a right on the part of the pledgee to receive the interest, as well as the principal, of the pledged bonds. Of course, the filing of the § 77 petition, and the concomitant suspension of all payments on secured debt, constituted defaults under all of the instruments involved.

When bonds owned by Penn Central are not pledged, the bonds are not included in the calculation of the retained asset coverage and no distribution is made to Penn Central as owner of the bonds. The analysis is more complicated, however, when bonds owned by Penn Central are pledged to secure another obligation. An owner of the New York Central 6% Collateral Trust Bonds due in 1980, one of seven collateral trust indentures secured in whole, or in part, by $119 million in R & I bonds, has objected to the way the Trustees allocated the R & I's retained assets to his Collateral Indenture.

R & I bonds in the principal amount of $156 million are owned by the public, in addition to the $119 million of Penn Central-owned R & I bonds pledged under these seven collateral trust indentures. The Trustees' analysis proceeds as follows: The first step is to marshall the security for the seven collateral indentures by initially applying security other than R & I bonds. The next step is to determine the extent to which the balance of the collateral claim (the "net claim" of the collateral trust indentures) is secured by retained assets represented by the R & I bonds pledged. For that purpose, the total amount due on the R & I bonds (the "base claim" on the R & I bonds) is calculated at $333.981 million, representing the total principal amount of the outstanding bonds, plus interest

on the bonds held by the public. The retained assets allocable to the R & I mortgage (approximately $98 million) provide 29.3% coverage.[79] That percentage is applied to the principal amount of the R & I bonds pledged under each collateral indenture, in order to determine the retained assets attributable to each such collateral indenture. The remaining R & I retained assets are, of course, allocated to the claims of the public holders of R & I bonds. Where this calculation renders some of the collateral indentures more than fully secured by retained assets, the excess is then marshalled among the issues not thus fully secured.

The objection is that it is inappropriate to exclude interest on the pledged bonds in calculating the allocation of retained assets to the collaterals. If interest were included, there would be significant changes in how the R & I retained assets were allocated among the collaterals *inter se* and as between the collaterals and the public holders of R & I bonds. For example, including interest on the collateral bonds would decrease the retained asset coverage of the public holders from 29.7% to 26.4%, but would increase the retained asset coverage of the New York Central 6% of 1980 from 58% to 71%.[80]

While the exclusion of interest on pledged R & I bonds appears at first blush to be an unfair discrimination against the holders of collateral trust bonds, this is not the case. Interest on the pledged bonds was not recognized prior to default, whereas interest did accrue and was paid on the publicly held R & I bonds. Thus, the Trustees' approach comports with the actual way the bonds were treated. More importantly, including interest on the pledged bonds for the purpose of computing the retained asset coverage

79. For the complete calculations, *see* note 68 *supra.*

80. See page A292.

80. Collateral Trust Bonds—015 Mortgage

Mtg. #	Description		Net Claim	Claim on 015 Assets**	Underlying Security	Underlying Security Versus Net Claim: Deficiency	Underlying Security Versus Net Claim: Excess	Distribution of Excess	Total Distribution
CTB	PC 6½	1993	$ 140	$ 5,760	$ 1,492		$1,352	$ 170	$ 140
CTB	NYC 6	1980	26,967†	73,018	18,911	$ 8,056			19,081†
CTB	NYC 5¼	1980	248	1,243	322		74		248
CTB	NYC 5¾	1980	685	2,537	657	28			661
CTB	NYC 6	1990	1,117	5,369	1,391		274		1,117
CTN	NYC 5	1974	14,012	40,195	10,410	3,602		88	10,498
109	CR&I		13,001	35,929	9,306	3,695		82	9,388
	Total	015	56,170	164,051	42,489	15,381	1,700	344	41,133
015—1	R&I A	2013	125,689	125,689	32,553	93,136		792	33,345
015—3	R&I C	2013	89,119	89,119	22,082	67,037		561	23,643
	Total 015 bonds		214,808	214,808	55,635	157,410		1,353	56,643
	Grand Total		$270,978	378,859	98,124*	174,679	1,700	1,697*	98,121*

STEP 1. To allocate retained assets first determine the percentage that total retained assets are of all claims on 015 assets (98,000/378,859 = 25.9%). The amount of 015 assets available to satisfy a claim is computed by multiplying the claim by the percentage. (*E.g.*, NYC 6s of 1980: 25.9% of $73,018 equals $18,911 available).

STEP 2. To allocate the excess of 015 assets first determine the net claim unsatisfied by subtracting from the total net claim the net claim of collateral indentures which have excess 015 assets ($270,978 — $1,505 = $269,473). Divide the excess by the net claim unsatisfied to give the percentage excess assets are of the net claim unsatisfied ($1,700/$269,473 = .63%), and multiply each unsatisfied claim by that percentage.

† Retained asset coverage of the NYC 6's of 1980: $19,081/$26,967 = 71%.

* Discrepancy due to rounding.

** Figures taken from brief of Samuel Schuckman (Doc. No. 14620).

of the collateral trust bonds would be a form of double-dipping. All collateral trusts have had interest added to their claims and they are treated as fully secured under the Plan. To include interest on the pledged R & I bonds would be, in effect, giving the collaterals preferential treatment.

Admittedly, the Trustees' solution does not represent the only possible way out of this labyrinth. But it produces a result which is at least as fair to all creditors as any other solution which might be devised.

e. Carthage & Adirondack

A further refinement of the retained asset allocation problems discussed in the preceding section is the correct treatment of bonds held, not by Penn Central itself, but by its subsidiaries. For purposes of computing the percentage of retained asset coverage of a particular mortgage, the total claim of the mortgage is the aggregate amount due on all outstanding bonds held by others than Penn Central itself (*i.e.*, the holdings of subsidiaries are included in the total claim). The Plan does not, however, provide for any distributions in payment of bonds held by either Penn Central or its subsidiaries; all such bonds will simply be cancelled. Manufacturers Hanover Trust Company, as Indenture Trustee of the Carthage & Adirondack Mortgage, contends that the bond holdings of subsidiaries should be excluded in calculating the retained asset coverage of its mortgage. If that were done, the percentage of retained asset coverage of that mortgage would be increased.

This objection lacks merit. The fundamental purpose of the retained asset analysis is to accord to creditors the same respective positions relative to each other that they would enjoy in the absence of a Plan. In the absence of a Plan, subsidiary-held bonds would have to be reckoned

with, and it is entirely proper to take them into account in determining retained asset coverage.

In any event, the fact that the Plan makes a partial concession, by excluding subsidiary-held bonds from the distributions under the Plan, is simply not a valid reason for insisting upon further concessions. Here again, the treatment of all mortgages is uniform.

H. Claims for Priority Under the "Six Months Rule"

In some circumstances, unpaid claims stemming from a railroad's operations during the six months period before the filing of the bankruptcy petition are entitled to priority over the claims of mortgagees and other secured creditors. The "six months rule," as it has come to be known, was developed by the courts in the early days of railroad receiverships, and later refined and qualified. Because it is based entirely upon equitable considerations, and because the equities of different cases may be perceived differently by different courts, application of the rule has not always produced consistent results.

The six months rule is made applicable in proceedings under § 77 of the Bankruptcy Act by virtue of § 77(b), which provides, *inter alia*:

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors . . . .

See Generally 5 *Collier on Bankruptcy* § 77.21, at 573 (14th ed. 1974).

In the present case, creditors holding claims in excess of $60 million seek priority treatment under the six months rule, and it is therefore necessary to determine whether they would have been entitled to such priority if this were an equity receivership proceeding instituted on June 21, 1970.

1. Definition and Development of the Six Months Rule

The six months rule has been developed and analyzed in literally scores of reported cases, and has been the subject of much scholarly comment over the years. Only so much of this history as is essential to an understanding of the application of the rule in the present case will be mentioned here.

The rule was first recognized by the Supreme Court in the famous dictum in *Fosdick v. Schall*, 99 U.S. 235, 25 L. Ed. 339 (1878), where the Court expressed its concern that railroads in financial difficulties would seek to postpone mortgage foreclosure proceedings by allowing current operating expenses to go unpaid, so that the money which normally would be used to pay such operating expenses could be paid to the mortgagee. The Court reasoned that if that happened, and if the mortgagee later sought the aid of the court to achieve an orderly and beneficial foreclosure, the mortgagee would have no grounds for complaint if the court-appointed receiver used the current earnings of the railroad to pay the unpaid operating expenses. The Supreme Court stated:

> In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. The income out of which the mortgagee is to be paid is the

> net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment, and useful improvements. Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income. If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before any thing derived from that source goes to the mortgagees.

Id. at 252-53. The Court further stated that, even if no provision for such payment of outstanding current debts were made in the order appointing the receiver,

> if . . . it appears in the progress of the cause that bonded interest has been paid, additional equipment provided, or lasting and valuable improvements made out of earnings which ought in equity to have been employed to keep down debts for labor, supplies, and the like, it is within the power of the court to use the income of the receivership to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business. This, not because the creditors to whom such debts are due have in law a lien upon the mortgaged property or the income, but because, in a sense, the officers of the

> company are trustees of the earnings for the benefit of the different classes of creditors and the stockholders; and if they give to one class of creditors that which properly belongs to another, the court may, upon an adjustment of the accounts, so use the income which comes into its own hands as, if practicable, to restore the parties to their original equitable rights. While, ordinarily, this power is confined to the appropriation of the income of the receivership and the proceeds of moneyed assets that have been taken from the company, cases may arise where equity will require the use of the proceeds of the sale of the mortgaged property in the same way. Thus it often happens that, in the course of the administration of the cause, the court is called upon to take income which would otherwise be applied to the payment of old debts for current expenses, and use it to make permanent improvements on the fixed property, or to buy additional equipment. In this way the value of the mortgaged property is not unfrequently materially increased. . . . Under such circumstances, it is easy to see that there may sometimes be a propriety in paying back to the income from the proceeds of the sale what is thus again diverted from the current debt fund in order to increase the value of the property sold. The same may sometimes be true in respect to expenditures before the receivership. No fixed and inflexible rule can be laid down for the government of the courts in all cases. Each case will necessarily have its own peculiarities, which must to a greater or less extent influence the Chancellor when he comes to act. The power rests upon the fact, that in the administration of the affairs of the company the mortgage creditors have got possession of that which in equity belonged

> to the whole or a part of the general creditors. Whatever is done, therefore, must be with a view to a restoration by the mortgage creditors of that which they have thus inequitably obtained. It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of the diversion.

Id. at 253-54.

The Court thus laid down broad equitable principles for later refinement and application on a case-by-case basis. The subsequent development of the rule can be properly understood only if one recognizes that the entire law of bankruptcy was then in its infancy; that many of the claims benefitted by the rule's priority (*e.g.*, wage claims) are no longer dependent upon the rule for priority treatment; and that the rule developed in what were relatively straightforward mortgage foreclosure proceedings.

Perhaps the fundamental legal concept to be kept in mind is that, until the debtor was ousted from possession of the mortgaged property, the lien of the mortage did not extend to the earnings of the company. While the mortgagee's claim against income was solidified by the appointment of a receiver following default, it was still desirable to have the railroad continue functioning; and this often necessitated, as a practical matter, payment of pre-receivership operating expenses. Moreover, in many of the early cases, the mortgage being foreclosed had been created in connection with an overly optimistic program of expansion of the railroad; the completion of certain capital projects already under construction obviously benefitted the mortgage security. It is also important to bear in mind, as pointed out in the SEC Report (at 94 n.159) that there are "semantic pitfalls" in attempting a literal transposition of the language of the reported cases to the problems of today, as financial and accounting concepts have grown more sophisticated.

Before any right to priority under the six months rule can be established, it must appear that the obligation was incurred as an expense of current operations, in the ordinary course of business, for material or services used in the operation of the railroad; that the creditor expected to be paid out of the current operating receipts of the railroad (as distinguished from reliance upon the general credit of the railroad); and that the claim arose within six months before the filing of the petition. For purposes of the present discussion, it will be assumed that all of the claims for which six months priority is sought meet these criteria. But it must also appear that a fund exists, or should equitably be recreated, for the satisfaction of six months claims; and this aspect of the rule requires further discussion.

2. *The "Current Debt Fund"*

By definition, six months claimants have extended credit in reliance upon the current revenues of the railroad. This does not mean that anyone—and, specifically, the mortgagees—can be said to have guaranteed that current revenues will always be sufficient to pay all current operating expenses.

The six months creditor's claim to current revenues is superior to that of the mortgagee, but it does not extend to the "corpus" of the estate except to the extent that current revenues have been improperly diverted for the benefit of the mortgagee.

The six months rule, when properly applicable, gives the claims of six months creditors priority over the claims of pre-bankruptcy secured creditors; it does not grant priority over administration claims.

Finally, the rule is based upon equitable considerations governing what the receiver/trustee should do to achieve the proper balance between the claims of operations creditors and the claims of other creditors; and its application is therefore limited to the revenues and other assets in the possession or control of the receiver/trustee.

When the foregoing principles are kept clearly in mind, most of the confusion in the language of the reported cases, and in the briefs of the parties in these proceedings, concerning pre- and post-bankruptcy revenues, gross versus net revenues, surplus revenues, diversions and free funds, disappears.

Perhaps the most thorough discussion of the six months rule, its history and ramifications, is contained in Judge Anderson's excellent opinion in *In re N.Y., N.H. & H. R.R.*, 278 F. Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999, 89 S. Ct. 1592, 22 L. Ed. 2d 776 (1969) (*New Haven case*), in which the possible sources of payment of six months claims (*i.e.*, the "current debt fund") were summarized as follows: [81]

81. The inclusion of unmortgaged assets is based upon the decision in an early Second Circuit case, *Pennsylvania Steel Co. v. New York City Ry.*, 216 F. 458 (2d Cir. 1914), which has been followed in several other early cases. The only rationale for this inclusion seems to have been notions of "public policy," in that six months creditors contributed to the operation of the railway, whereas other unsecured creditors hindered such operations. I have great difficulty squaring this reasoning with the fundamental basis for a six months priority, namely, reliance of current operations creditors upon current revenues.

However, it is probable that the Third Circuit Court of Appeals has accepted the Second Circuit's statement of the nature of the priority of operations claims expressed in the *Pennsylvania Steel case*. *See Central R.R. of New Jersey v. Manufacturers Hanover Trust Co.*, 421 F.2d 604, 609 n.14 (3d Cir. 1970).

In the *New Haven* case, it was made clear that "unmortgaged assets" are indistinguishable from "cash and other current assets," since the lien of mortgages would have attached to everything else

> Such a fund may arise out of one or more of the following: (a) current earnings in the sense of surplus earnings during the six months period and during the reorganization itself; (b) unmortgaged assets of the debtor; and (c) income diverted during the six months period or during the reorganization for the benefit of the mortgagees.

278 F. Supp. at 598.

This formulation represents a distillation of the expressions of a large number of earlier cases. The District Court Opinion in that case was affirmed on appeal, and has been referred to favorably by our own Third Circuit Court of Appeals. *See Central R.R. of New Jersey v. Manufacturers Hanover Trust Co.*, F.2d 604 (3d Cir. 1970). It will therefore be adopted here.

a. Net Income Rather Than Gross Income

The six months claimants argue that the current debt fund includes all of the current income of the estate, rather than "surplus" or "net" income. In my opinion, this would be correct only to the extent that "diversions" for the benefit of mortgages can be shown. The debts owed to six months creditors have priority over debts owing to other pre-bankruptcy creditors, which remained unpaid when the petition was filed, but six months creditors are not in a position to insist that non-operating current debts paid by the railroad before bankruptcy be refunded; moreover, the receiver/trustee is responsible only for the funds coming

81. (Cont'd.)

by virtue of the after-acquired property clauses of the mortgages. The mortgage liens attach to cash and other current assets upon default, but since these items were produced by the goods and services supplied by the operations creditors, these operations claims take precedence over mortgage liens with respect to those assets.

into his hands. Hence, the use of "surplus" income for the pre-petition six months period is clearly correct. Since the six months claims do not have priority over administration claims, and since all expenses of current operations after bankruptcy are in that category, the use of "net" or "surplus" income for the post-petition period is also clearly correct.

b. Inclusion of Non-Rail Income

The Trustees have argued that only income produced by rail operations is to be considered. The six months claimants contend that all of the Debtor's income is to be taken into account. The existence of this controversy points up the lack of absolute consistency between the way the rule has been applied in the decided cases, and the stated reasons upon which the rule is based.

If the basis for the rule is the notion that operations creditors are entitled to share in the income which their goods and services have helped to produce, there is no logical reason for extending the priority to reach non-operational income. The *New Haven* case appears to have so held. 278 F. Supp. at 600 n.12. But if that is the basis for the rule, there would likewise be no justification for extending the priority to "unmortgaged assets" (except to the extent of "diversions" from net income). Yet several cases, including the *New Haven* decision itself, 278 F. Supp. at 602, have held, or at least stated, that unmortgaged assets, if any, should be devoted to the payment of six months claims, before those of other pre-bankruptcy unsecured creditors.

As many courts and commentators have pointed out, it is simply impossible to reconcile the language or the holdings of all of the reported cases on the six months rule. Some of the difficulty stems from the intermingling of several discrete equitable concepts, and from the tendency to overstate the equities favoring the parties in whose favor decision is being rendered. The notion that operations creditors who contribute to the continued operation of the enterprise ought to share in the income produced by continued operations seems, in many of the reported decisions, to merge into the notion that operations creditors who enable the railroad to keep operating ought to receive some special recognition even though the railroad has long been, and will continue to be, a hopeless loser. The latter concept, in turn, is based upon the assumption that continuation of the "going concern," even at a loss, benefits secured creditors. Intertwined with these concepts is the theme that the operations creditors extended credit in reliance upon the current earnings of the railroad, and should be regarded as quasi-secured by that current income.

Sorting out these various concepts, and giving consideration to each in the context of the present case, it would seem that the calculation of a current debt fund should probably include not only the revenues directly produced by rail operations, but the total net income of the Debtor to the extent that it was customarily made available for the support of rail operations, and hence could properly have been relied upon by operations creditors as a source of payment. This is, of course, intended to be limited to "earnings," not proceeds from sales of capital assets or other extraordinary items.

c. Determination as of Distribution Date

In the *New Haven* case, it was squarely held that the relevant date for determination of a current debt fund is the date of distribution. That is, for purposes of determining the net income component of a possible current debt fund, one looks at the entire history of the railroad's operations, beginning six months before the petition was filed and extending through the end of such operations

during bankruptcy. The fact that on a given day, or for a given week or month, current income may have exceeded current obligations then paid is not decisive; cash flow is not the criterion. The issue is whether there was any current income above administration expenses that should have been used for the payment of six months claims.

I accept this reasoning as essentially correct. While it is of no significance in the present case, I suggest that there may be cases in which a further refinement would be appropriate. For example, if operating income exceeded operating expenses for a considerable period after a bankruptcy petition was filed, so that the six months claims should have been paid, but thereafter the Debtor's fortunes declined, and prolonged deficit operations wiped out the previous surplus, it may be that some equitable adjustment should be made in favor of the six months claimants. But that is not our case.

It should also be emphasized that, in computing a current debt fund as of the present time, any "diversions" during the entire period must be taken into account.

d. Accounting Methods

As stated by Judge Anderson in the *New Haven* case,

> The words used must be interpreted in the light of a generally recognized and accepted system of accounting. . . . While a rigid and mechanistic application of accounting terms should not be adopted to thwart the equitable consideration which the courts have afforded six months claimants, such terms, recognized and used for more than half a century, should not be so distorted, for the purpose of granting the six months creditors a recovery, that the terms no longer relate to the concepts for which they have traditionally stood and are no longer descriptive of the Railroad's financial operations. The phrase "generally accepted accounting principles" does not mean precisely the same thing in all businesses because allowances must be made as the Interstate Commerce Commission has said, 309 I.C.C. 289, 293 (1959), "for variations among different industries because of special conditions or long-established usage." As far as this present case is concerned, any difference between the Interstate Commerce Commission's prescribed system of accounting for railroads and "generally accepted accounting principles" is minor and falls within the tolerance which the generally accepted practice allows for the railroad industry.

278 F. Supp. at 599-600.

In affirming this decision, the Second Circuit Court of Appeals stated:

> We hold that the availability of a current expense fund under the six months rule is to be determined by generally accepted accounting practices, including those prescribed by the Interstate Commerce Commission, and that under those practices the current expense fund is to be computed by deducting operating expenses and depreciation from operating revenues.

405 F.2d at 52.

3. The Existence of a Current Debt Fund in the Present Case

a. The Earnings Component

In 1970, which includes all but 11 days of the six months period plus the first six months of bankruptcy, the Debtor experienced a deficit in net railway operating in-

come aggregating $236,518,000. It received gross income from non-rail sources in the amount of $66,550,000 ($55,145,000 net). There was thus a deficit of total income in the sum of $169,968,000, and a deficit in income available for fixed charges in the sum of $181,373,000.[82] It seems obvious that the most relevant figure for present purposes is the latter, income available for fixed charges. It is stretching matters somewhat to include non-rail income at all; surely there is no basis for disregarding the cost of obtaining that income.

The deficits in income available for fixed charges for the succeeding years are as follows: 1971, $148,435,000; 1972, $67,311,000; 1973, $53,908,000; 1974, $53,515,000; 1975, $196,238,000; 1976 (first 3 months), $53,515,000.

The magnitude of these deficits amply demonstrates the unavailability of any net income component of a current debt fund. Further discussion is unnecessary.

I have not overlooked the point that the amounts owing to the six months claimants are included in the current expense calculations which produce the net loss for that year. But so long as the deficit in income available for fixed charges, as shown on the Schedule 300 filing, is in excess of the total amount of the six months claims, there would be no income available for the payment of six months creditors. Thus, adjusting the 1970 net loss figure to eliminate the unpaid six months claims would still leave a deficit in income available for fixed charges of approximately $120 million.

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82. Unless otherwise indicated, the figures used in this section are derived from the Debtor's schedule 300 filings with the ICC. The figures are summarized in tabular form in the exhibits attached to the Trustees' Memorandum in Support of its Position Statement (Doc. No. 12994), and in attachments to the affidavit of Norman Hull, Vol. 1, p. 43.

b. Diversions from Earnings to Benefit Secured Creditors

During the entire period, from six months before bankruptcy until April 1, 1976, Penn Central paid a total of $13,231,000 in interest, and $6,149,000 in principal, on its secured debt, for a total of $19,380,000 in direct payments for the benefit of secured creditors. During the same period, it expended $220,699,000 on capital improvements to mortgaged property, but accrued $25,854,000 in retirements (write-offs of non-depreciable property) and $544,209,000 in depreciation.

Expenditures from operating income for improvements of mortgaged assets are considered "diversions" for the benefit of secured creditors, at the expense of the six months creditors, whose claims should have been paid out of that income. Expenditures for the preservation or repair of mortgaged assets are not diversions. *St. Louis, A. & T.H. R.R. v. Cleveland, C.C. & I. Ry.*, 125 U.S. 658, 667-78, 8 S. Ct. 1011, 31 L. Ed. 832 (1888). By the same token, depreciation, which reflects the consumption of assets for the purpose of running a railroad, does not result in enhancement, and is not to be regarded as diversion. *In re N.Y., N.H. & H. R.R.; Burnham v. Bowen*, 111 U.S. 776, 781-82, 4 S. Ct. 675, 28 L. Ed. 596 (1884).

The six months claimants argue, however, that the Trustees' method of accounting for depreciation in this context amounts to "double-dipping," since depreciation has already been deducted in computing net operating income. I am inclined to believe that this point is well taken, but the result in this instance remains the same. If the company had actually set aside cash reserves for depreciation, in the amounts shown on the annual income statements, the company could have expended that reserve to correct the physical depreciation of the mortgaged

assets, and would not thereby have enhanced the mortgaged assets at the expense of the six months claimants. But if that had occurred, the properties would not now be in a depreciated condition, there would be no occasion for a further deduction in computing the capital expenditure accounts, and any further sums spent for actual improvements would constitute diversions. But the crucial factor here, in my judgment, is that taking depreciation into account only once, rather than twice, it is still evident that no diversion has occurred.

The aggregate of the deficit in income available for fixed charges for the entire period is $754,295,000. Since the unpaid six months claims (approximately $60 million) should be eliminated from the calculation of operating deficits, the correct figure for present purposes is $694,295,000. The aggregate of the depreciation already deducted in arriving at that figure is $544,209,000. Thus, disallowance of depreciation as a factor in computing net income still leaves a deficit in income available for fixed charges in the sum of $150,086,000, so there is no earnings component for a "current debt fund." And the actual expenditures for capital improvements ($220,699,000) are far less than the actual depreciation of the properties which has occurred ($544,209,000), so there has been no enhancement and no diversion.

The final, and rather obvious, point to be made with respect to the claimed diversions is that even if enhancement of the value of mortgaged assets had occurred, restoration for the benefit of six months claimants could be required only if operating income of the Debtor had been used for that purpose. As noted above, I have given these claimants the benefit of the doubt, and have rejected the Trustees' not insubstantial argument that non-rail income should be excluded. The fact remains, however,

that pre-bankruptcy payments on account of secured debt were made possible only by sales of assets and extensive borrowings; and that operations during bankruptcy were made possible only through additional borrowings, on Trustees certificates and under the § 215 and § 211(h) programs of the RRRA, greatly in excess of all expenditures which even arguably benefited secured creditors. Thus, even if there had been enhancement of the properties securing the mortgages, "free funds" (*i.e.*, other than income) made the expenditures possible, and there is no basis for allowance of the priority claimed by the six months creditors.

c. Unmortgaged Assets

In the interests of completeness, mention should be made of the absence of unmortgaged assets as a potential source of payment of the claims of six months creditors. Although, as mentioned above (*see* note 81 *supra*), there are conceptual difficulties in arriving at an acceptable rationale for giving six months claims priority with respect to unmortgaged assets of the estate, that issue need not be pursued in this case. The pervasive lien of the Government-guaranteed Trustees certificates, and of the Government's § 211(h) claims, have effectively eliminated the concept of unmortgaged assets, in the present context. Acceptance of the Government compromise does free up cash for the payment of certain personal injury claims, state and local taxes and other unpaid administration expenses, but leaves no room for payment of six months claims from that source. Moreover, absent the Government compromise, the recent decision of the Third Circuit Court of Appeals in the consolidated cases of *In re Penn Central Transp. Co., appeal docketed; In re Lehigh Valley R.R., appeal docketed,* and *In re Reading Co., appeal docketed,* 570 F.2d 1189 (3d Cir., Feb. 3, 1978), would

seem to provide a further barrier precluding access of six months claims to the Debtor's cash and current assets.

Further discussion of this issue is unnecessary. Actually, no six months claimant has asserted that unmortgaged assets represent a potential source of payment of the claimed priority.

4. Claims for Priority Based Upon the "Necessity of Payment" Rule

Closely related to, and sometimes confused with, the "six months" rule is the "necessity of payment" doctrine, established in such cases as *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 25 S. Ct. 415, 49 L.Ed. 717 (1905); *Miltenberger v. Logansport Ry.*, 106 U.S. 286, 1 S. Ct. 140, 27 L. Ed. 117 (1882); *In re N.Y., N.H. & H. R.R.*, 278 F. Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999, 89 S. Ct. 1592, 22 L. Ed. 2d 776 (1969). As summarized by Judge Hastie for the Third Circuit Court of Appeals:

> These cases permit immediate payment of claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims shall have been paid.

In re Penn Central Transp. Co., 467 F.2d 100, 102 n.1 (3d Cir. 1972).

A group of creditors, most notably Consolidated Edison Corporation and various other electric utilities, Trailer Train, and the interline railroads, have asserted that their claims are entitled to priority under the necessity of payment doctrine.

The two rules are related because the six months priority cannot be claimed except with respect to goods or services which were, at least in a general sense, "necessary"

to the operation of the railroad. That is, all of the claimants advancing the "necessity of payment" doctrine are also claiming "six months" priority. The distinction to be observed, however, is between whether the goods and services were necessary for rail operations (one facet of the six months rule), and whether *payment* of the claim was necessary to enable the railroad to continue operating (the necessity of payment rule). If a creditor, by refusing to deal with the railroad during reorganization unless his pre-bankruptcy claims are paid, threatens to make continued operations impossible, then, as a matter of economic necessity, the Trustees may properly be permitted to pay such claims, even out of the corpus of the estate. By definition, the necessity of payment rule is one to be invoked by Trustees, as justification for their decision to pay these unsecured pre-bankruptcy claims. Ordinarily, then, there would be no occasion for creditors to seek priority treatment in a plan of reorganization on the basis of the necessity of payment rule; rather, creditors would invoke the rule by applying economic sanctions, which, if effective, would trigger a request by the Trustees for authority to pay out under the rule. In the absence of that kind of business judgment by the Trustees, there is no occasion for a reorganization court to invoke the necessity of payment doctrine.

As a general proposition, therefore, the Trustees are undoubtedly correct in pointing out that the "necessity of payment" doctrine has no application to the present case, since failure to pay the claims now being considered did not interfere with the conduct of rail operations, and since the Trustees are no longer operating a railroad.[83] The

83. In connection with the transfer of operating responsibilities from Penn Central to ConRail, the economic factors undergirding the necessity of payment doctrine are reflected in the § 211(h) agency arrangement, which assures payment of post-bankruptcy operations creditors and thus avoids disruption of ongoing business

"necessity" claimants assert, however, that this defense is not available in the present case for two reasons: (1) The decision of the Fourth Circuit Court of Appeals in *Southern Ry. v. Flournoy*, 301 F.2d 847 (4th Cir. 1962), and certain language in an earlier Opinion of this Court, *In re Penn Central Transp. Co.*, 328 F. Supp. 1276, 1278 (E.D. Pa. 1971), *aff'd*, 467 F.2d 100 (3d Cir. 1972), establish that the necessity of payment rule is a rule of priority, and not of payment; and (2) they justifiably relied upon both of these cases, assumed that "necessity of payment" would be recognized as a basis for granting them priority, and therefore refrained from exerting the economic sanctions which would have triggered immediate payment of their claims in order to protect the continued operation of the railroad. The argument is that these creditors should not now be penalized because they proceeded in a civilized fashion, and did not resort to the "law of the jungle."

It is true that, if the *Flournoy* case was correctly decided and if it represents the law of this Circuit, the claims now being considered would be entitled to priority treatment. But, as was amply demonstrated by Judge Anderson in the *New Haven* case, the *Flournoy* court simply confused the "necessity of payment" rule with the "six months" rule. Its decision is contrary to the decision of the Supreme Court in *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 25 S. Ct. 415, 49 L. Ed. 717 (1905). In any event, its decision does not represent the law of this Circuit, as set forth in *In re Penn Central Transp. Co.*, 467 F.2d 100 (3rd Cir. 1972).

It is also true that this Court's dictum in the case mentioned above (which referred to the rule as providing that "certain unsecured claims incurred in operating the rail-

83. (Cont'd.)
relationships. Implicit in the § 211(h) program is the assumption that non-payment of prebankruptcy claims poses no threat to ConRail's operations.

road may be entitled to priority over secured claims, on the theory that the corpus would be unjustly enriched otherwise," 328 F. Supp. at 1278, and that "assuming the existence and applicability of this doctrine, it does not require immediate payment, but rather deals with the assignment of priorities as among claims," *id.*) represents either a thoroughly garbled statement of the "six months" rule or a partial adoption of the dicredited *Flournoy* approach which impermissibly combines the two rules. This unfortunate dictum does not, however, give rise to equities favorable to these claimants. Even taking this Court's language at its face value, and assuming it had remained the last word on the subject, the creditors were told that "assuming the existence and applicability of this doctrine" they might be entitled to priority over secured claims "on the theory that the corpus would be unjustly enriched otherwise." That statement surely does not amount to a guarantee that their claims would be granted priority merely by virtue of the nature of the claim; and it remains true that these claims would be given priority if "unjust enrichment" of the corpus securing the mortgages (*i.e.*, diversions) could be shown.

More importantly, this Court's Opinion was not the last word on the subject. Whatever confusion and inaccuracy may have existed in this Court's formulation was eliminated on appeal; Judge Hastie's Opinion for the Court of Appeals clearly sets forth the correct statement of the necessity of payment doctrine. Needless to say, the Court of Appeals decision is controlling. And no creditor, having read the Court of Appeals Opinion, could be under any illusion that he need not attempt to exert economic sanctions, or that withholding such action would result in priority treatment in the Plan.

Indeed, the principal thrust of both this Court's Opinion and the Court of Appeals Opinion was to suggest the

unlikelihood that any creditor could successfully insist upon payment of pre-bankruptcy claims as a condition of continuing to do business with the Debtor. This Court had directed the Trustees to pay all current utility bills during reorganization, but refused to require the Trustees to pay pre-bankruptcy claims in that category. The Court of Appeals affirmed. Similarly, in the case of the interline railroads, this Court ordered the Trustees to pay all such claims presented after bankruptcy, but declined to order payment of pre-bankruptcy claims. *In re Penn Central Transp. Co.*, 340 F. Supp. 857 (E.D. Pa. 1972). The Court of Appeals affirmed (except that it concluded that certain of the pre-bankruptcy accounts involved "trust funds belonging to the interline creditors and not to the Debtor's estate). 486 F.2d 519 (3d Cir. 1973), *cert. denied*, 415 U.S. 990, 94 S. Ct. 1588, 39 L. Ed. 2d 886 (1974). The combined effect of these decisions can properly be said to reflect the full extent to which the "necessity of payment" doctrine should be recognized in this entire proceeding; namely, that it justifies judicial mandates requiring current payment of post-bankruptcy claims of such creditors, rather than merely authorizing their payment (or, as in the case of tax claims, simply deferring them).

All else aside, the necessity of payment doctrine, by its very nature, depends for its applicability upon the economic realities of the market place, and the dominant or subservient positions of the parties. It is simply unrealistic to suggest, for example, that an electric utility such as Con Ed would even consider cutting off a customer paying it well over $1 million per month (and paying it promptly, under a Court order) merely because a single month's pre-bankruptcy bills remained unpaid. And it is obvious that the interline railroads, to whom Penn Central service was essential, were never in a position to sever relationships, and thus could never qualify under the necessity of payment rule.[84]

With respect to other suppliers, alternative sources of supply were always available to an enterprise of the size and strength of Penn Central. The possibility of invoking the necessity of payment doctrine simply did not arise.

I. Other Assertions of Priority Status

1. Bank Setoff Claimants

When the reorganization petition was filed, Penn Central had substantial sums of money on deposit with numerous banks throughout the country, and also owed very substantial sums to many of those banks; these debt obligations were unsecured. Under state law, these banks had the power to obtain immediate payment of their loans by simply setting off Penn Central's deposits against the amount owed. However, Order No. 1, supplemented by specific injunctive orders of this Court, prohibited the banks from exercising their right of setoff, thus ensuring that the deposited funds would continue to be available to the Debtor. A group of these banks (herein denominated for convenience as the "Setoff Banks") which had an aggregate of $6.97 million of Penn Central's deposits when the reorganization petition was filed, now assert that they should be treated as secured creditors for purposes of the Plan.

In rejecting challenges to the earlier injunction against setoffs, neither this Court nor the Court of Appeals, *In re Penn Central Transp. Co.*, 315 F. Supp. 1281 (E.D. Pa. 1970), *aff'd*, 453 F.2d 520 (3d Cir.), *cert. denied*, 408 U.S.

84. Some diversion of traffic to other, non-bankrupt, lines may have been possible, and some no doubt occurred, but the direction to pay post-bankruptcy interlines currently served to obviate this difficulty for the most part. Moreover, since all of the major Northeastern railroads were in bankruptcy, the interline railroads were not in a strong bargaining position.

923, 92 S. Ct. 2493, 33 L. Ed. 2d 334 (1972), reached the question of how the claims of such banks should be treated in the Plan. But in a later decision involving Penn Central, in reviewing a decision from another circuit which had permitted a shipper to set off claims for freight loss and damage against the Penn Central Trustees' claims for freight charges due, the Supreme Court held that the setoff should not have been allowed. *Baker v. Gold Seal Liquors,* 417 U.S. 467, 94 S. Ct. 2504, 41 L. Ed. 2d 243 (1974). The Court reasoned that to permit an unsecured creditor to exercise a right of setoff would result in granting that creditor a priority over other unsecured creditors to the extent of the setoff, and that such priority would be inconsistent with the fair and equitable treatment of all creditors mandated by § 77. The Setoff Banks have now presented vigorous and scholarly arguments to the effect that the *Baker* case was either wrongly decided or would be decided differently today; and that in any event bank setoffs are unique and therefore distinguishable from the shippers setoffs involved in the *Baker* case. Notwithstanding the earnestness with which these arguments have been pressed, I find it impossible to avoid the conclusion that the Plan correctly treats the claims of the Setoff Banks as unsecured claims.

Evaluation of the banks' arguments begins with recognition of the fact that bank deposits simply do not constitute either security in the normal legal sense of that term, or the functional equivalent of security.[85] Until the banks'

85. A commentator cited by the Setoff Banks, although supporting the right to set off, has dealt crisply with the equivalent of the security argument.

> The analogy to 'security' is hardly convincing since the bank may not der .nd that deposits be made in order to create a right of setoff for fear of losing deposits as a preference under sections 60 and 68 [of the Bankruptcy Act]. Nor may the bank rely on deposits since they may be withdrawn at any time by the debtor. While superficially representing security

right of setoff is actually exercised, the depositor may withdraw any or all of the funds, and other creditors of the depositor can reach them by levy or attachment. From the moment the reorganization petition was filed and approved, federal bankruptcy law became the source of the rights of the Debtor, and thereafter of the Trustees. The banks were prohibited from exercising their right of setoff after the petition was filed. This prevented the banks from improving their position from that of an unsecured creditors to secured creditors. Thus, the banks were treated the same as other unsecured creditors, all of whom were also prohibited from levying upon the Debtor's bank deposits. If one were to accept the banks' argument that the injunction somehow provides a basis for treating their claims as secured claims, it would seem to follow that all unsecured claims must be treated as secured, since all creditors were prohibited from attaching bank deposits.

It is asserted, however, that the claims of these banks are unique, because of the existence of "compensating balance" arrangements between Penn Central and the banks. A compensating balance arrangement is simply an agreement between the depositor and the bank to the effect that the average amount on deposit will not fall below a specified minimum balance.[86] It seems clear that the

85. (Cont'd.)

> for any debt, the debtor's commercial deposits are not a voluntary or consensual security arrangement as is understood in commercial transactions.

Justman, *Comments on the Bank's Right of Setoff Under the Proposed Bankruptcy Act of 1973,* 31 Bus. Lawyer 1607, 1612 (1976).

86. Whether the Setoff Banks' compensating balance arrangements with Penn Central were informal or "formal contractual agreements, both explicit and implicit by which the parties were bound" (Doc. No. 14175, p. 3) has been a contested point. The contest is without moment. If a binding contract existed, the only benefit would be that the Setoff Banks would have a pre-reorganization claim for damages. It is the funds which were on deposit which are in issue.

principal purpose of such arrangements is to enable the bank to be assured of its ability to use the depositor's money for investment purposes, and thus to obtain some measure of compensation for the services it provides in connection with the bank account. In addition, of course, the ability to derive benefits from the depositor's bank account may well affect the availability and terms of loans to the depositor.[87] Failure of the depositor to maintain the required minimum balance ordinarily has no more serious consequences than a request to take the account elsewhere, or to pay for the services rendered, and perhaps a less cordial attitude toward future credit applications or requests to extend existing lines of credit.[88]

The Setoff Banks now contend that a further principal purpose of the compensating balance arrangements with Penn Central was to reassure the bank as to the financial soundness of its unsecured loans to Penn Central, because of the existence of the right of setoff.

Even assuming these banks sought minimum balances for the specific purpose of enabling them to exercise their right of setoff, I fail to see how that alters the situation. The fact remains that the banks did not exercise their right of setoff before bankruptcy. An agreement between Penn Central and creditor *X* assuring him of preferential treatment in the event of bankruptcy would plainly be null and void. An agreement between Penn Central and a bank to the effect that, in the event of bankruptcy, Penn Central would permit the bank to exercise a right of setoff after the bankruptcy petition was filed would fare no

87. A recent empirical study indicates that compensating balances are sought because of the earnings on the deposits, the favorable effect such deposits have on the bank's reserve position, and the increased yield on the loan. Baxter & Shapiro, *Compensating Balance Requirements: The Results of a Survey,* 19 J. Finance 483 (1966).

88. The documentary evidence submitted by the Setoff Banks demonstrates the accuracy of the description in the text.

better. And if an express agreement of that kind would be unenforceable, surely the arrangements described by the Setoff Banks do not justify conferring secured status upon the banks' claims.

The banks rely in part upon a footnote to the *Baker* opinion, in which the Court referred to its earlier opinion in *Lowden v. Northwestern Nat'l Bank & Trust Co.,* 298 U. S. 160, 56 S. Ct. 696, 80 L. Ed. 1114 (1936), and stated that, "The preference sought here shows no exceptional circumstances which in equity justify the discrimination;"[89] and upon a statement in the text that "to the extent that [the setoff] is allowed, it grants a preference to the claim of one creditor over others by the happenstance that it owes freight charges that the others do not."[90] The banks argue that all setoffs which do not arise from happenstance constitute exceptional circumstances under the *Baker* decision; that their compensating balances did not arise from happenstance but were bargained for; and therefore that the Setoff Banks should be treated as secured creditors. I believe this is a misreading of the *Baker* opinion.[91] The Court's rationale was simply that unsecured creditors should all be treated alike. The Setoff Banks are unsecured creditors. Moreover, the amount actually on deposit at any given time is a happenstance; and so is the coincidence of a depositor relationship with a lending bank, at least when compared with a formal pledge of collateral

89. 417 U.S. at 474 n.13, 94 S. Ct. at 2509.

90. 417 U.S. at 474, 94 S. Ct. at 2508.

91. Reliance is placed on the note accompanying § 7-204 of the bankruptcy statute proposed by the Commission on the Bankruptcy Laws of the United States. The report of the Commission was filed before *Baker* was decided. The report of the House Judiciary Committee concerning the House version of a new bankruptcy act, H.R. 8200, while supporting a procedure which would insure that when setoff is enjoined the creditor should be treated as secured, also points out that such treatment is inconsistent with *Baker*. House Judiciary Comm. H.R. Doc. No. 595, 95th Cong. 1st Sess. 183-86 (1977).

or other legally effective security interest. Indeed, it seems probable that the "exceptional circumstances" language of the *Baker* Court was intended to cover, for example, a lender who was fraudulently induced by a borrower to refrain from exercising a setoff which would otherwise have been asserted before bankruptcy.

The Setoff Banks' brief contains an additional argument which is not altogether clear. The claim is that unless the Setoff Banks are treated as secured creditors, they will have been denied procedural due process. Apparently, this refers to their alleged lack of opportunity to demonstrate the nature of the agreements between Penn Central and the banks. But the procedural orders which governed the Plan proceedings were quite elaborate, and accorded full opportunity for all to present evidence and argument. In fact, the banks did file a supplementary evidentiary submission; it was not subjected to, and has been considered by the Court. Due process has been accorded, but the banks' request to be treated as secured creditors must be rejected.

2. *Interline Railroads' Equitable Lien and Setoff Theories*

Closely related to the interline railroads' claims for priority under the six months and necessity of payment rules, discussed and rejected in Section II-H, are their claims for priority based upon theories of equitable lien and setoff. Earlier attempts by the interlines to obtain payment of their prebankruptcy claims on the basis of these theories were rejected by both this Court and the Third Circuit Court of Appeals, but neither Court has had occasion to consider the possible bearing of these arguments upon the treatment of the interlines' claims in a Plan of Reorganization. For the reasons which follow, I have concluded that the interline railroads' claims are not entitled to priority treatment.

The primary interline accounts are freight and passenger, car repair, overcharge and loss and damage, switching, and per diem. In the previous litigation, the following principles were established: (1) Freight and passenger account balances are trust funds, and such balances in the hands of Penn Central belong to the interline railroads and must be paid currently; (2) All other accounts are not trust funds, and the pre-bankruptcy amounts due other railroads need not be paid during reorganization; (3) Other railroads may not setoff the balances due from Penn Central (other than trust funds) against the balances owed by such railroads to Penn Central; and (4) subject to their right to set off trust fund balances due from Penn Central, the interline railroads must pay the account balances owed to Penn Central. *In re Penn Central Transp. Co.*, 340 F. Supp. 857 (E.D. Pa. 1972), *aff'd in part and rev'd in part*, 486 F.2d 519 (3d Cir. 1973), *cert. denied*, 415 U.S. 990, 94 S. Ct. 1588, 39 L. Ed. 2d 886 (1974) (*Trust Funds Case*). Under the Plan, pre-bankruptcy interline accounts totaling more than $20 million are treated as unsecured claims.[92]

a. Equitable Lien

The interline railroads contend that they are entitled to an equitable lien on the Debtor's assets, subordinate only to claims of administration. This argument is pressed as an alternative more sweeping, formulation of the interlines' six months and necessity of payment theories.

It is clear that the interline accounts are not secured by any consensual security arrangement. And, as the interlines appear to concede, the traditional concepts of equitable jurisprudence which would support the imposi-

92. The interlines' brief, Doc. No. 13783, also refers to certain remaining post-bankruptcy pre-conveyance interline balances which were still unpaid. These are all to be paid under the so-called "netting program" of Order No. 3029.

tion of an equitable lien do not apply here. Rather, the interline railroads contend that, since they were compelled by law to render services to Penn Central, their claims are unique; and that this legal compulsion justifies creation of an equitable lien. In my judgment, the premise is dubious, and the asserted conclusion is a non sequitur.

Stripped of its equitable trappings, the interlines' argument amounts to an assertion that other railroads may not be permitted to sustain any economic losses in a § 77 reorganization proceeding. There is simply no basis for such a preference in the Bankruptcy Act, and to create one by judicial fiat (if indeed that could lawfully be done) would be inequitable. The interline carriers have been the primary beneficiaries of the reorganization process. Their business relationships with Penn Central continued without interruption, and they received the benefit of the revenues thus derived. Alone among all of Penn Central's creditors, they benefitted from the continued operation of the railroad by Penn Central and, incidentally, will presumably continue to benefit from ConRail's operations. The "trust funds" portion of their pre-bankruptcy claims have been paid in cash, as have all of their post-bankruptcy claims. In stark contrast, state and local taxes remain unpaid and the preservation of the rail system so essential to the interlines' revenues has been achieved at heavy cost to the secured creditors.

It is argued that unless this Court imposes an equitable lien for the benefit of the interline railroads, they will have been relegated to the position of "involuntary sureties of the other creditors of Penn Central." The logic of this assertion escapes me. The interlines are not sureties for anyone, nor have they suffered any detriment for the benefit of other creditors. Surely, it would be impermissible to deprive the secured creditors of the property interests represented by their security in order to provide

priority treatment for the unsecured claims of the interline railroads.

Ultimately, the interlines' argument is simply that priority status must be accorded because of the "compelled business dealings imposed on the interlines." The compulsion stems from the nature of the interlines' business. Moreover, there are no unpaid obligations stemming from post-bankruptcy dealings, compelled or otherwise. The voluntariness or involuntariness of the relationship is simply irrelevant in this context.[93]

b. Setoff

Thirteen of the interline railroads earlier attempted to set off approximately $6 million in pre-bankruptcy account balances owed to them by Penn Central, against amounts they owed Penn Central. Various Orders of this Court precluded them from achieving such setoff, and they now assert that they should be treated in the Plan as secured creditors. For the reasons discussed in Section II-I-1, where the same argument made by the setoff banks was rejected, I am satisfied that these claims must be treated as unsecured. In applying the doctrine of the *Gold Seal Case,* I perceive no basis for distinguishing between the claims of the banks and those of the interline carriers.

Although not specifically argued in connection with the setoff issue, I have considered whether the allegedly compulsory nature of the business relationship between the Debtor and the interlines has any bearing on the setoff question, and have concluded that it does not.

c. Per Diem Accounts

The claims of the interline railroads include approximately $8.4 million owed by Penn Central for use of rail

93. Indeed, the only significance of the alleged compulsion would seem to be that it renders the necessity of payment rule totally inapplicable.

cars belonging to other railroads. In the *Trust Funds Case,* the Third Circuit Court of Appeals affirmed this Court's holding that per diem accounts were not trust funds and that pre-bankruptcy claims in that category need not be paid immediately. Later, however, the Court of Appeals of the Seventh Circuit held that although per diem accounts were not trust funds, pre-bankruptcy balances in that category may not be deferred during reorganization, but must be paid currently. *Chicago, R. I. & Pac. R.R.,* 537 F.2d 906 (7th Cir. 1976), *cert. denied,* 429 U.S. 1092, 97 S. Ct. 1102, 51 L. Ed. 2d 537 (1977). That decision was based primarily upon an argument which had not been raised in the *Trust Funds Case,* namely, that an order of the Interstate Commerce Commission requiring prompt payment of per diem accounts was binding upon railroads in reorganization, by virtue of § 77(c)(2) of the Bankruptcy Act. The interlines now ask this Court to follow the *Rock Island* holding to the extent of according some form of priority to their per diem claims.

Strict application of *res judicata* and law of the case principles would seem to preclude reconsideration of this matter, but the equitable nature of a reorganization proceeding counsels a more flexible approach, and I shall therefore consider the issue on its merits. Unfortunately for the interlines' position, however, the Third Circuit Court of Appeals has recently rejected the very same arguments which carried the day in the *Rock Island* case. *In re Penn Central Transp. Co.,* 553 F.2d 12 (3d Cir. 1977) *(Per Diem Case).* It follows that the per diem claims cannot be accorded any form of priority.

The *Per Diem Case* presented the issue of how interline account balances outstanding on the date of conveyance of the Debtor's rail properties to ConRail should be treated. Although Congress had provided, in § 211(h) of the RRRA, a mechanism for funding Penn Central's pre-

conveyance payables, the cash actually available for that purpose immediately after the conveyance was quite limited. The question was, which claims should be paid first. I directed immediate payment of the "trust fund" portion of the interline accounts, but notwithstanding the arguments made by the ICC in support of immediate payment of per diem accounts in compliance with its orders, I declined to require immediate payment of per diems, and the Third Circuit Court of Appeals affirmed. The Court of Appeals held: (1) The *Trust Funds Case* did decide that per diem claimants "are in the same position as other unpaid suppliers," and the failure of the interline carriers to call attention to the ICC's per diem order in that litigation did not impair the continued validity of the *Trust Funds Case* holding; (2) in any event, § 601(b)(4) of the RRRA rendered the ICC per diem order irrelevant to the issues before the Court; and (3) to the extent that there was conflict between § 77 of the Bankruptcy Act and the ICC per diem order "with respect to the time, mode and amount of per diem payments," [94] the conflict must be resolved against the ICC and the interline railroads. The Court concluded its Opinion with the following language: [95]

> We have carefully considered the contentions raised on this appeal. Far from eroding our confidence in the *Trust Funds Case,* they reinforce our view that the case was correctly decided and that it controls this appeal. We cannot distinguish the *Trust Funds Case;* nor would we be inclined to re-examine it if that were in our power which, of course, it is not. A panel of this Court cannot overrule a decision of the court en banc, and, as we have noted, the *Trust Funds Case* was decided by the court en banc.

94. 553 F.2d 12, 16.

95. 553 F.2d 12, 16-17.

The *Per Diem Case* is controlling, and requires rejection of the interlines' claim for priority treatment of per diem.[96]

Moreover, if the issue were still open in this Circuit, I should decline to adopt the *Rock Island* court's choice among the conflicting policy interests at stake here.[97] The principal basis for that decision was the court's belief that failure to accord priority to per diem claims could result in the interline railroads subsidizing the car rentals of § 77 debtors. While this may be true to a limited extent, to accord decisive weight to that factor is to treat the entire question as merely a matter of arbitrating private arrangements between the railroads, and does not give proper weight to the interests of other claimants and the public. It simply creates a preference for railroads over all other creditors, for no other reason than that they are railroads.

Whenever a railroad petitions for reorganization under § 77, there is concern lest other railroads dependent upon the Debtor for sustenance may also be forced into reorganization. And there is an undeniable public interest in avoiding this "domino effect." But in my judgment, that problem is best addressed on an *ad hoc* basis, within the framework of the necessity of payment doctrine, rather than by judicial creation of a blanket priority rule which

96. The interlines have carefully selected a few sentences of the Third Circuit's opinion and developed an argument to the effect that the *Per Diem Case* adopts the Seventh Circuit's approach. Reading the opinion as a whole, however, it is not possible to accept the interlines' position.

97. If the Seventh Circuit Court of Appeals' approach is correct, all that need be done to insulate railroads from all consequences of § 77 proceedings is for the ICC to promulgate an order incorporating the American Association of Railroads' Rules relating to the payment of interline accounts. Such a result is simply inconsistent with § 77. If the railroads of the nation are to be insulated, it is Congress which should make that decision.

Indeed, the Congress is in the process of considering this question. Compare § 1164 of H.R. 8200 (95th Cong. 1st Sess.) with § 1169(a) of S. 2266 (95th Cong. 1st Sess.).

has not been sanctioned by Congress.[98] In any event, it is clear that the "domino" argument is irrelevant to the treatment of claims in a plan of reorganization; that argument relates to the actions to be taken during the early stages of the reorganization proceeding.[99]

A railroad does not petition for reorganization under § 77 of the Bankruptcy Act if it is able to pay its bills. Unless "breathing room" can be provided by holding creditors at bay for a reasonable period, reorganization is impossible. A blanket rule immunizing interline accounts from deferral places a powerful weapon in the hands of the interline carriers, the Debtor's competitors, enabling them virtually to control the Debtor's fate. I respectfully suggest that the *Trust Funds Case* has gone about as far in that direction as can be tolerated if § 77 of the Bankruptcy Act is to achieve its laudable goals.[100]

The interline railroads also assert that failure to accord per diem claims priority would be contrary to public policy, in that it would inhibit the growth of the rail car fleet of the nation's railroads. There is no evidence that the original rulings in this case, in 1972, had any such effect. Moreover, the traditional view has been that a principal purpose of the reorganization process is to

98. *See, e.g., In re Penn Central Transp. Co.*, 325 F. Supp. 294 (E.D. Pa. 1970).

99. Needless to say, the asserted "domino effect" is not limited to other railroads. As the experience of this case demonstrates, the impact of Penn Central's filing for reorganization was felt most harshly by Penn Central's non-railroad suppliers, particularly the smaller firms, many of which were forced into, or to the brink of, bankruptcy.

100. Even if the Third Circuit Court of Appeals were to reverse its position and hold that per diem accounts should be paid in § 77 proceedings, how that new rule should be applied in pending § 77 proceedings is uncertain. It would be necessary to carefully consider the rights of all creditors, as well as the implications of reliance by this Court and the parties on the *Trust Funds Case*.

stabilize the economic environment and create a climate which will encourage private investment in railroad enterprises. Promoting per diem accounts over the liens of secured creditors would have precisely the opposite effect.[101]

3. Freight Loss or Damage Claims

When goods are lost or damaged in transit, the liability of the carrier to the shipper is virtually absolute. The shipper may have recourse against any of the carriers involved in the shipment, without being required to prove fault. When a carrier pays such a claim, it has a right (a) to recover from the offending carrier the full amount of the claim which it has paid, if it can show that the loss or damage occurred while the goods were in the control of that carrier; or (b) if the circumstances do not permit a determination as to which carrier had control of the goods when the loss or damage occurred, to recover a pro rata portion of the amount expended from the other carriers involved in the shipment. Rules of the Association of American Railroads establish the formulae to be applied in determining the pro rata share of each of several carriers involved in a shipment, as well as the procedures to be followed in asserting and processing such claims.[102]

101. If the Court of Appeals had mandated immediate compliance with its trust fund decision, Penn Central's rail operations would have come to a halt. If the trust funds doctrine had been the law of this Circuit when the petition was filed, a similar crisis might well have occurred, unless, of course, the officials of the company had foreseen the impact of the doctrine and filed the petition sooner. Any doctrine which discourages procrastination in filing a petition which must inevitably be filed is undoubtedly beneficial; but the history of railroad reorganizations in this country provides little basis for optimism that the doctrine will have that effect.

102. *See* Appendix to *In re Penn Central Transp. Co. (Interline Balances)*, 340 F. Supp. 857 (E.D. Pa. 1972), *aff'd in part and rev'd in part*, 486 F.2d 519 (3d Cir. 1973).

For present purposes, the significant features of the AAR rules and arrangements are these: (1) The shipper may assert the claim against any of the carriers involved, and may alter its decision as to which carrier to pursue, so long as the claim has not been reduced to judgment; but once the shipper has obtained a judgment against a particular carrier, he may not thereafter seek recovery from any of the other carriers. (2) A carrier's right to obtain indemnity or contribution from one or more of the other carriers involved does not arise until the carrier has paid the claim of the shipper. And (3) all claims for indemnity or contribution among the carriers are netted out and settled in the normal, ongoing process of settling interline accounts.

In the normal course of railroad operations, the task of investigating claims for freight loss and damage, both to determine the merit of the claim itself, and to determine whether or not responsibility of a particular carrier can be fixed, often takes many months, or even years; and the paperwork involved in the interline settlement process can also be time consuming. Thus, the actual exchange of funds between carriers bears little or no temporal relationship to the assertion of the claim by the shipper, or even to the initial payment to the shipper.

Because of the nature of interline accounting, the distinction between pre-bankruptcy and post-bankruptcy claims in this context is essentially arbitrary. Interline settlements first presented for payment after June 21, 1970, have been treated as post-bankruptcy claims, and have been paid on a current basis.[103] Interline claims

103. Post-bankruptcy interline claims remaining unpaid on the date of conveyance of the railroad to ConRail, April 1, 1976, after some initial confusion and uncertainty, have been, and are being, taken care of through the ConRail Agency Agreement and the § 211(h) program.

presented before bankruptcy, and remaining unpaid on the date the petition was filed, are treated as pre-bankruptcy obligations. However, to the extent that, under the ruling in *In re Penn Central Transp. Co.*, 477 F.2d 841 (3d Cir.), *probable jurisd. noted, United States Steel Corp. v. Penn Central Transp. Co.*, 414 U.S. 885, 94 S. Ct. 231, 38 L. Ed. 2d 137, *cert. denied*, 414 U.S. 923, 94 S. Ct. 219, 38 L. Ed. 2d 157 (1973), *aff'g and rem'g*, 339 F. Supp. 603 (E.D. Pa. 1972), a trust relationship arose (*e.g.*, freight charges), these claims, too, have been paid.

In short, the pre-bankruptcy interline claims remaining open for disposition in the Plan of Reorganization are those claims which were presented before bankruptcy, and in which only a normal debtor-creditor relationship existed. Claims for freight loss and damage are in this category.

When the bankruptcy petition was filed, most, if not all, of the shippers who had claims for freight loss and damage which could have been asserted against either Penn Central or some other carrier, abandoned their claims against Penn Central and asserted them against other, non-bankrupt, carriers. Penn Central's obligations with respect to such claims are reflected in the post-bankruptcy program of interline settlements. Thus, the only shippers' claims for pre-bankruptcy freight loss and damage which remain to be disposed of under the Plan are those in which Penn Central was the only carrier involved in the shipment, or in which the claim against Penn Central had already been reduced to judgment. The Plan classifies these claims as within Class M, general unsecured.

The claims in question undoubtedly arose before bankruptcy, and undoubtedly are unsecured. Indeed, the claims arising from shipments where Penn Central was

the only carrier involved do not differ in any material respect from typical unsecured pre-bankruptcy claims. But the claims arising from shipments in which other carriers were also involved have a unique attribute: When these claims are "paid" by the distributions contemplated in the Plan, Penn Central may be able to obtain full or partial reimbursement from other carriers. The Trustees are undoubtedly correct in their contention that any sums thus recovered would not constitute trust funds under the Court of Appeals' Opinion cited above, or on any other basis; nevertheless, the question remains whether the distributions contemplated in the Plan give proper recognition to this unique characteristic of the claims.

The first point to be noted is that this possibility of a future subrogation [104] right does not enhance the "value" of the shipper's claim entitled to treatment in the Plan. At the present time, and on the consummation date, the "value" of each such claim is the same as any other unsecured claim of a general creditor. Thus, for purposes of the absolute priority rule, it is appropriate to rank these claims in Class M, without distinction.

The circumstances which may be said to give rise to equitable considerations favorable to such claimants will not arise until after the consummation date, perhaps long after that date. If the Trustees thereafter pursue a claim for reimbursement from other railroads, and *if* responsibility for the loss can be fixed on some other railroad, or cannot be fixed at all, some benefits may then accrue to the estate. But the shippers have no right to require the Trustees (or the reorganized company) to pursue subrogation; the right of subrogation does not arise until the shipper's claim is discharged under the Plan; and it is

104. The term "subrogation" is not technically correct, but is a useful shorthand description of the indemnity/contribution rights under the AAR Rules.

impossible to ascertain at this juncture just which claims may give rise to subrogation rights, or in what amount.

Notwithstanding these uncertainties, and the impossibility of attributing a present value to the estate of whatever subrogation rights may arise, it might be possible to require, as an adjunct to the consummation process, that the net proceeds of any such subrogation recoveries should somehow be utilized so as to expedite or enhance the ability of the affected shippers to obtain cash payment under the Plan. That is, cash later received by the reorganized company from other railroads might be used to underwrite repurchase of, or additions to, the securities distributed to these shippers.

Unfortunately, however, the practical obstacles to any such arrangement appear formidable. The reorganized company will not receive cash from other railroads, and will not even be managing the subrogation process. All such matters are a part of the agency arrangement between the Trustees and ConRail. It is not at all clear that the detailed accounting and tracing which would be required to implement any such adjustments would be compatible with the terms of the agency agreement.

The most that can be said, as a practical matter, is that after claims of this type are discharged under the Plan, ConRail may obtain subrogation recoveries which will have the effect of slightly reducing the total amount of the Government's § 211(h) claims. Given the magnitude of the § 211(h) claims, I believe that, in the context of this Reorganization Plan, the impact of that speculative reduction can properly be regarded *de minimis.*

Moreover, since there could be no Reorganization Plan at all except for the Government's willingness to defer its § 211(h) claims, I perceive no lack of fairness in declining to pursue this matter further. The claims of these shippers are properly classified and fairly treated under the Plan.

4. Priority of the United States under Revised Statutes 3466

Two aspects of the Plan's treatment of the Government's claims against the Debtor are in dispute. One is a long-pending dispute involving alleged income tax deficiencies, including interest, in excess of $50 million, going back as far as 1954. Section 7 of the Plan provides that when this tax liability is resolved, any amount due the Government will be satisfied in B notes or assumed by the reorganized company. The Government contends that R.S. 3466 requires that such tax claims be paid in cash. The other dispute involves a claim of the United States for approximately $2 million in pre-bankruptcy unsecured obligations. Unless this claim is within R.S. 3466, it will be treated as an unsecured claim, but if R.S. 3466 does apply, the claim will be within Class L and satisfied with B notes. The Government asserts that R.S. 3466 does apply to its pre-bankruptcy claims but acknowledges that although such claims should ordinarily be paid in cash, B notes are acceptable.

a. Pre-bankruptcy Claims

R.S. 3466 provides as follows:

> Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts,

> makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

The essential question dividing the parties is whether or not the commission of an act of bankruptcy triggers the application of R.S. 3466. Penn Central's filing of a § 77 petition when it was unable to meet its debts as they matured constitutes the fifth act of bankruptcy. However, that does not mean that Penn Central was then or is now insolvent.

The controlling case is *United States v. Oklahoma*, 261 U.S. 253, 43 S. Ct. 295, 67 L. Ed. 638 (1923). The Government concedes that in that case the Court specifically stated that R.S. 3466 applied only in instances in which a debtor was insolvent in the bankruptcy sense, *i.e.*, its liabilities exceeded its assets. Indeed, the Court held that the United States' allegation that a bank was insolvent under state law was inadequate on its face because state law defined "insolvency" as the failure to be able to meet debts as they accrue. The Court went on, however, to examine whether or not the Government had alleged adequate facts to constitute the commission of what was then the fourth act of bankruptcy, the voluntary relinquishment of assets to a receiver or trustee. At that time, the fourth act of bankruptcy was committed only when a debtor's assets were voluntarily conveyed to a receiver or a trustee when the Debtor was also insolvent in the bankruptcy sense. The Court concluded that the Government had not pleaded adequate facts to constitute the fourth act of bankruptcy because the bank had been involuntarily placed in receivership by state banking commissioner. The important point, however, is that under the bankruptcy law as it was then written, the act of

bankruptcy which the Court inquired into required that the debtor be insolvent in the bankruptcy sense.

Under the present version of the Bankruptcy Act an act of bankruptcy is committed by the filing of a § 77 petition by a debtor which is insolvent in the bankruptcy sense or unable to meet its debts as they mature. The Government therefore argues that Penn Central's § 77 petition brought R.S. 3466 into play. *United States v. Oklahoma* did not determine the issue now before this Court because the act of bankruptcy there considered did require that the debtor be insolvent in the bankruptcy sense.

R.S. 3466 has been the subject of much debate for many years. The case law is quite extensive, but to some extent inconclusive. With respect to the issue under discussion, the Government has not cited any case which is controlling. As pointed out above, *United States v. Oklahoma* is not conclusive; indeed, there is ample ground to argue that that case points to a result exactly opposite to that sought by the Government.

The complete implications and policy ramifications of R.S. 3466 are discussed in detail in Plum, *The Federal Priority in Insolvency: Proposals for Reform*, 70 Mich. L. Rev. 3 (1970). The governing law is summarized as follows: [105]

> Although the first clause of § 3466 appears to give the Government priority 'whenever any person indebted to the United States is insolvent,' the Supreme Court, viewing the provision as a whole, has determined that, except in the case of a decedent's estate, something more than insolvency is required. The insolvency of a living debtor must be manifested by (1) 'a voluntary assignment' made by one not

105. 70 Mich. L. Rev. 3, 12-13 (1970).

having sufficient property to pay his debts, (2) the attachment of the estate and effects of an absconding, concealed, or absent debtor, or (3) the commission of an act of bankruptcy (even though not followed by a bankruptcy proceeding).

I subscribe to the view that R.S. 3466 is applicable only when the debtor is insolvent in the bankruptcy sense and one of the additional events specified in the statute occur, including an act of bankruptcy.

The remaining question is whether the Debtor is insolvent in the bankruptcy sense. No one knows the answer to that question; the answer will be revealed at the conclusion of the Valuation Case. The problem then becomes one of burden of proof. The Government suggests that this problem should be solved in the unique circumstances of this case by adopting a compromise solution; namely, that in lieu of satisfaction of its asserted unsecured claims in cash the Government should receive B notes. If the Trustees had proposed such a compromise, it might well have been approved. However, they have steadfastly refused to compromise the Government's claim on that basis.[106]

There is support for the proposition that when a solvent debtor files a reorganization petition R.S. 3466 may apply if at the time of distribution the debtor is insolvent. *Hatch v. Morosco Holding Co.*, 61 F.2d 944 (2d Cir. 1932), *cert. denied*, 288 U.S. 613, 53 S. Ct. 404, 77 L. Ed. 986 (1933). That suggestion, while not easily squared with the language of the statute, does make sense, but the issue has never been decided squarely by the Supreme Court. There is a special difficulty in this case in deciding whether or not insolvency must exist at the time the petition was filed or at the time of distribution. At the time of distribution whether or not the Debtor is insolvent will still be unknown. Concededly, the issue is a difficult one, but ultimately the severance of the Debtor's estate into retained and conveyed assets and the resultant lack of information concerning the Debtor's solvency is a condition not within the control of the Trustees or any of the parties interested in the Penn Central estate. In such unique circumstances, I am persuaded that the appropriate solution is to hold that the Government is not entitled to priority under R.S. 3466.

106. It may be permissible to require the Trustees to incorporate in the Plan "compromise" proposals they are unwilling to accept (see Section II-C); but in view of their fiduciary obligations to all concerned, I prefer not to do so.

b. Tax Claims

For some time now the Trustees and the United States have been attempting to arrive at a settlement of the income tax claims. There is now under review, by the various governmental agencies involved, a settlement proposal tendered by the Trustees. Counsel for the United States has informed the Court that the proposals are "within a reasonable range of settlement." The settlement proposal involves payment of modest amounts of cash, B notes, the release of certain refund claims, and the possibility of reducing the Debtor's accumulated net operating loss carry-forwards. Consummation of this settlement or any similar arrangement would not have any effect on the feasibility of the Plan.

Because the pending settlement proposal specifies the manner of satisfaction of the Government's claim, consummation of the proposal would obviate the need to decide the validity of the Government's objections to the Plan. Of course, one of their objections, the failure to recognize their priority under R.S. 3466, has been disposed of ad-

versely to the Government above. In addition, § 77(e) contains a special procedure for handling Government tax claims. A § 77 plan which provides for payment of the Government tax claim in an amount less than the established tax obligation, may not be confirmed unless there is actual acceptance of the plan by the President or his delegate or the President fails to act within 90 days of receipt of the plan. Hence, at confirmation the United States will be free to argue that B notes constitute payment of a "lesser amount" of its tax claim.

Therefore, the following possibilities exist: The tax claim settlement proposal will be accepted by the United States and the matter will be at an end if this Court approves the settlement. If no settlement is reached, it will be necessary to liquidate the claim before this Court. At the time of confirmation, the United States will be able to assess the situation and determine whether or not B notes are satisfactory to it and if not, to reject the Plan as it pertains to their tax claims. In that event, there may or may not be an issue concerning whether or not the rejection is valid under § 77(e). Perhaps at that juncture the Trustees would choose to provide an alternate method of satisfaction. The point simply is that § 77(e) contemplates a procedure which takes place at confirmation rather than at approval.

J. Class G Claimants

Administration claims, other than those of the United States, taxing authorities, and persons entitled to compensation or reimbursement for expenses under § 77(c)(2) or (c)(12) are Class G administration claims. For the most part, the claims which may fall within Class G are either contingent or disputed by the Trustees. One such dispute will be resolved if this Court approves a recently proposed

settlement between Amtrak and the Trustees. ConRail has also asserted a number of claims in litigation, which if proven to be valid, will be treated as Class G claims.

Under the Plan, Class G claimants are to receive C-2 notes. These notes bear interest at 8% compounded annually and mature on December 31, 1987. C-2 notes and the tax authorities' C-1 notes have a claim to the proceeds of the Valuation Case subordinate only to the B notes distributed to the United States. The interest of the C-1 and C-2 notes is to be satisfied first, then the principal. If any interest or principal is not paid, the remaining portion of the C-1 and C-2 notes will be discharged.

1. Amtrak

National Rail Passenger Corporation ("Amtrak") has asserted various claims against the Debtor's estate, none of which has yet been liquidated. These claims include miscellaneous accounting claims under the operating arrangements between Amtrak and Penn Central, claims that Penn Central has an obligation to rebuild all of the highway bridges over the Northeast Corridor, and claims for alleged pre-conveyance breaches of Penn Central's contract obligations to maintain its tracks for Amtrak's benefit. The Trustees have acknowledged some potential liability on the accounting claims, but have vigorously contested the validity of the claims in the remaining two categories, and have asserted that any such obligations would be more than offset by the amounts due and owing from Amtrak to Penn Central when the final compensation arrangements between the two are established by the Interstate Commerce Commission pursuant to the Amtrak statute. 45 U.S.C. § 562.

Irrespective of the merit or lack of merit in any of the claims asserted by Amtrak, the Court must be satisfied that

the Plan provisions are adequate to accommodate, in a fair and equitable manner, whatever liability may be established; and that the feasibility of the Plan would not be undermined by even the most adverse likely outcome.

Amtrak did not participate in the Plan hearings, except to the extent of filing a brief written objection to the Plan. Accordingly, so that this Court might be further enlightened as to the nature and amount of Amtrak's claims, and perhaps even resolve some of them on their merits, a further hearing to explore the Amtrak situation was held on December 9, 1977.[107] Although Amtrak was not in a position to present evidence in support of any of its claims, and could provide no more than very rough estimates of the total amounts claimed in each category, some elucidation of Amtrak's legal theories was provided, and the Court was placed in a somewhat better position to assess the fairness and feasibility of the Plan provisions pertinent to Amtrak's claims. Shortly thereafter, however, the Court was advised that the parties were pursuing a possible amicable resolution of all of their disputes, and that settlement seemed imminent. On February 24, 1978, a comprehensive settlement agreement was presented to the Court for approval. Service of the proposed settlement agreement is being made upon all participants in the Plan proceedings, and a hearing has been scheduled for April 7, 1978.

Under the proposed settlement, all of Amtrak's claims here pertinent would be liquidated in the aggregate

107. The hearing also embraced the issues presented by the Third Circuit Court of Appeals remand of one aspect of the track maintenance controversy, *In re Penn Central Transp. Co.*, 560 F.2d 169 (3d Cir. 1977), *vacating in part and aff'g in part*, 422 F. Supp. 67 (E.D. Pa. 1976), including its seeming direction to this Court to decide the post-conveyance maintenance liabilities of ConRail; substantial jurisdictional questions were therefore involved, in view of the exclusive jurisdiction of the Special Court under the RRRA.

amount of $40 million, and would be discharged by the payment of $15 million in cash over a three-year period, and the issuance of $25 million in C-2 notes. However, since Penn Central will cancel receivables due from Amtrak of approximately $6 million (which will correspondingly increase the estimated Section 211(h) claims), and will be required to pay $2 million to other parties, the total effect of the settlement will be $48 million. I express no view whatever as to the reasonableness of the proposed settlement, nor as to the likelihood of its being approved or disapproved. But since the function of the Court in the approval proceedings will be to determine whether the settlement is in the best interests of the Debtor's estate, it is appropriate for present purposes to assume that the claims of Amtrak will impose no greater burdens upon the estate than those embodied in the proposed settlement. That is, it is reasonable to suppose that the settlement will be approved unless the Court is convinced that it is unduly generous to Amtrak. It is therefore sufficient for present purposes to note that the terms of the proposed settlement can be carried out without doing violence to the Plan as submitted, and that no other interested party would have cause for complaint by reason of this treatment of Amtrak's claims.

2. *ConRail*

Penn Central acquired most of its rail equipment by conditional sale, lease, equipment trust, or some other form of vendor or third-party financing. Pursuant to § 303(b)(3) of the RRRA, the Trustees assigned their interests under these financing agreements to ConRail. There is now pending in the Special Court litigation between ConRail and the Trustees in which ConRail contends that after conveyance it made about $39.9 million in

equipment payments which were attributable to the pre-conveyance period and that under § 303(b)(3) the Trustees are liable to ConRail in that amount. ConRail has also asserted in that litigation a claim for about $14.7 million allegedly arising from the defective condition of certain conveyed equipment. The Special Court has denied the Trustees' motion to dismiss on jurisdictional grounds, but the case has not proceeded on the merits. The only issue before this Court is whether whatever claim ConRail may eventually establish before the Special Court may properly be satisfied in C-2 notes.

If it should become necessary to issue $65 million in C-2 notes (*e.g.*, $25 million to Amtrak and $40 million to ConRail), the interest on C-2 notes would be paid if the Valuation Case recovery in 1976 dollars is $326 million, and the principal would be paid if the recovery is $406 million. ConRail has not asserted that its treatment as a Class G creditor is unfair because the Valuation Case recovery will be less than $404 million, but rather that deferral of its claim is improper under § 77 and § 303(b)(3) of the RRRA.

Within the framework of § 77 and this Plan, there is no basis for treating ConRail better than other administration claimants. Neither the tax claimants nor the United States is paid fully in cash. It would indeed be anomalous if the entity which benefitted from the transfer of the Debtor's rail assets and the valuation standard of the RRRA were itself to be exempted from the consequence of the severance of the Debtor's estate into retained and conveyed assets and the delay in the recovery of the value of the conveyed assets.

If ConRail is entitled to payment in cash, all administration claimants would be entitled to the same treatment. In that event, it would be necessary to determine whether the very large claims of the United States and the tax authorities have priority over ConRail's claim. If they do, ConRail would have to wait until cash became available. That wait would be prolonged by litigation over the availability of escrow funds to satisfy administration claims and the allocation of administration claims among secured creditors. This is a familiar line of analysis. By and large the arguments made by ConRail for cash payment are the same as those unsuccessfully raised by the taxing authorities.

It is interesting to analyze ConRail's position as that of the subrogee of the equipment financier whose obligation was paid by ConRail. The equipment financier would ordinarily have to look to his collateral before participating under the Plan. In a very real sense, that is precisely the position in which the Plan places ConRail. C-2 notes do not mature until the conclusion of the Valuation Case, but the proceeds of the Valuation Case are, in effect, a statutory substitute for the equipment financier's collateral. The treatment provided for ConRail in the Plan is fair and equitable.

ConRail argues that no matter what result is reached under § 77, § 303(b)(3) of the RRRA supersedes § 77 and mandates payment of its claims in cash. That section provides in pertinent part:

> If [any equipment obligations] (accrued prior to the date of conveyance) are paid by or on behalf of any person or entity other than the assignor [Penn Central], such person or entity shall have a claim to direct reimbursement, as a current expense of adminministration, from such assignor together with interest on the amount so paid.

"Reimbursement" is argued to mean reimbursement in cash. Unfortunately, no legislative history has been cited

which either supports or negates ConRail's interpretation. But ConRail seeks to support its position with the following observation:

> The phrase 'direct reimbursement' is also utilized in Section 504(e) and 504(g) of the Rail Act where ConRail is given a claim to direct reimbursement against United States Railway Association ('USRA') in the form of a Section 211(h) loan after ConRail's assumption in payment of certain defined employee-related obligations. In that context, ConRail has always sought and received from USRA cash repayment.

USRA's interpretation of subsections (e) and (g) of § 504 is not quite binding authority concerning the proper interpretation of § 303(b)(3). Moreover, the differences between § 303(b)(3) and subsections (e) and (g) of § 504 conclusively refute rather than support ConRail's interpretation of § 303(b)(3).

Subsections (e) and (g) provide that under certain circumstances ConRail is entitled "to direct reimbursement from the USRA pursuant to § 211(h) of this Act." In contrast, § 303(b)(3) provides that ConRail "shall have a *claim* to direct reimbursement, as a current expense of administration." There is a vast difference between according ConRail the right to reimbursement by way of a § 211(h) loan and a *claim* for direct reimbursement which shall constitute an expense of administration. Section 303(b)(3) also requires that interest be paid on ConRail's claim, but there is no similar provision in either subsections of § 504. Thus, it is quite apparent that by incorporation of the § 211(h) funding mechanism in § 504 Congress intended speedy reimbursement of ConRail, but

the same conclusion cannot be drawn with respect to § 303(b)(3).

There is another interesting comparison of the statutory language. Under subsections (e) and (g) of § 504 when USRA makes a § 211(h) loan to ConRail, USRA is "entitled to a direct claim as a current expense of administration" against the Debtor whose obligation ConRail paid. If ConRail's interpretation of § 303(b) is correct, the absence of the phrase "direct reimbursement" in § 504 would mean that ConRail's claim against Penn Central is qualitatively better than USRA's claim against Penn Central under § 504. There is a similar incongruity in § 211(h). There ConRail is accorded a "direct claim, as a current expense of administration, for reimbursement from [an] estate . . . for all obligations of such estate (plus interest thereon) which are paid by [ConRail]." Again, ConRail's interpretation of § 303(b) would lead to the conclusion that its § 303(b) claims are to be treated better than its claims arising under § 211(h).

It is simply not plausible to suggest that Congress intended, when it used the word "reimbursement," to create a claim in favor of ConRail which was different in kind from the claims it created for ConRail under § 211(h) or for USRA under § 504(b). Rather, the most reasonable interpretation of these sections is that Congress intended to make certain that both ConRail and USRA would be treated as administrative claimants under § 77. The word "reimbursement" is used throughout the statute for the purpose of reinforcing the idea that ConRail would be satisfying a claim against the Debtors rather than its own obligation.

ConRail also argues that because of its delicate financial situation, Congress must have intended to grant ConRail a claim for immediate reimbursement in cash.

There is certainly no indication of that condition in the Final System Plan financial projections, which are all that Congress had available at the time. And as the Trustees point out, Congress was fully aware of the dire straits of the bankrupt estates at the time it enacted § 303(b). Congress repeatedly increased the funding of §§ 213 and 215, increased the scope of the latter, and added § 211(h), all for the purpose of alleviating the cash crisis caused by the Government-imposed cash management practices in the pre-conveyance period. In the absence of explicit language, it is not reasonable to suppose Congress intended to mandate a special preference for ConRail which would not only further drain the estates but also subordinate the Government trustees' certificates and § 211(h) claims to ConRail's equipment obligation claims under § 303(b).

K. Treatment of Guarantee Claims

A footnote to the schedule of unsecured claims states that certain claimed amounts have not been included in the totals of unsecured claims because these claims were "guarantee claims for which liability is deemed to have been assumed by another party or disaffirmance of the contingent liability is deemed to result in no damage." Penn Central is a sole or joint guarantor of bonds of several corporations which are not in any way affiliated with Penn Central. The Indenture Trustees under four of these guaranteed bond issues have objected, not to the Plan as such, but to the legal conclusions contained in the footnote quoted above.

Apparently, the Indenture Trustees are concerned that approval of the Plan might constitute a final determination that their guarantee claims may not participate under the Plan and are discharged. Approval of the Plan in no way precludes, however, the objecting Indenture Trustees from

seeking to establish their claims in the Proof of Claims Program. There is no dispute concerning the classification of any claim which they may be able to prove—all are unsecured claims.

Earlier in these proceedings the Trustees purported to disaffirm bond guarantees of Secondary Debtor bonds as well as third-party-issued bonds. Petitions were filed to annul that act of disaffirmance on the theory that a guarantee is not an executory contract which may be disaffirmed by a trustee in a § 77 reorganization. Although those petitions remain *sub judice,* the issues have been mooted by the filing of the Plan. The Secondary Debtor guarantees have become irrelevant because the Plans accord participation to the bondholders of the Secondary Debtors. As to the third-party guarantees, the issue is also now moot. The focus is no longer on disaffirmance, but on the status of contingent claims. In a §77 proceeding contingent claims are provable and dischargeable. Thus, it is in the Proof of Claims Program that the proper amount, if any, of the unsecured claims of the Indenture Trustees are to be established. A second possible issue is to what extent satisfaction of the unsecured claims would result in the reorganized company's being subrogated to the bondholders' claim against, and security interest in, the property of the third-party issuer. These issues are also amenable to resolution in the Proof of Claims Program.

Finally, Section 7 of the Plan contemplates if after consummation an unsecured claim is established, the reorganized company will discharge that claim by issuing the distribution provided in the Plan for unsecured creditors. Decision of the executory contract issue in favor of the Trustees' position would have had the limited procedural effect of fixing the date of accrual of the guarantee claim, whereas the combined effect of the dischargeability

of the guarantee claims and Section 7 of the Plan is to leave that question open. Of course, the parties may seek to have the underlying issues resolved at their convenience in further proceedings.

L. Equity Interests Held By Penn Central Company

Penn Central company owns 100% of the common stock of the Debtor. Under the Plan, it will receive 10% of the common stock of the reorganized company. This distribution would be impermissible if it were concluded that the Debtor is insolvent; that is, unless the total value of the Debtor's assets (including, here, the proceeds to be received from the Valuation Case) exceeds the amount owed to its creditors, the present stockholders would not be allowed to participate in the Plan distributions or voting. In the comments summarizing the Plan (Section II-B), I pointed out that, since no finding of insolvency could now legitimately be made, the Trustees' proposal to permit equity interests to participate is reasonable and should be approved. Conversely, however, I am also persuaded that no greater participation than the Plan provides can be justified on the present record.

Penn Central Company itself supports the Plan. However, various individual stockholders of the Penn Central Company, in person or through representatives, strenuously object to the Plan provisions. Upon analysis, it is clear that many of these objections relate not to the Plan, but to the outcome of the Chapter XI reorganization of the Penn Central Company, a matter over which this Court has no control.

Much has been made by one shareholder of the value of the Debtor's coal assets. The impression sought to be conveyed is that the coal assets have not been properly valued. This simply is not accurate. The coal assets

were a major aspect of the valuation of Pennco and have otherwise been the subject of intense management by Pennco and the Trustees. The SEC has discussed the coal properties in great detail in its report, and little would be served by repeating that discussion here.

The remaining objections are addressed, not so much to the Plan as to the governmental actions which, in the view of these objectors at least, created the circumstances which have made it impossible to achieve a Plan which would more favorably treat the equity holders.

I have carefully reviewed all of these objections, but have concluded that they do not justify rejection or modification of the Plan.

Part III

Secondary Debtors

Previous sections of this Opinion have dealt with various aspects of the relationship between the Penn Central's Plan and Penn Central's proposed Plans for the Secondary Debtors. All but one of the major disputes between the Penn Central Trustees and the Secondary Debtor Trustees have now been amicably resolved, and the Secondary Debtor Trustees have adopted the proposed Plans as in the best interests of their respective estates. Suffice to say, only the most compelling evidence would cause this Court to do other than accept the judgments of the Secondary Debtor Trustees who are directly charged with the fiduciary responsibility to protect those interested in their estates.

In connection with considering the challenges by the Penn Central interests (the Michigan Central Collateral Indenture Trustee and the PRR General Mortgage Indenture Trustee) to the key provision of the Secondary Debtor's Plans, the mutual cancellation of debts between

Penn Central and the Secondary Debtors, it became apparent that the mutual cancellation of debts compromise is well within the range of litigation results. The complexities of the legal and factual issues are immense. Nothing would be gained by reviewing in detail those issues. A further aspect of the Plans does merit mention. Consummation of the Plans will permit the reorganized company to conduct the Special Court Valuation Case litigation in a consolidated or unified way. Absent the Plans, the Valuation Case litigation might well turn into a donnybrook between Penn Central and the 15 Secondary Debtors, each seeking to gain the largest possible share of whatever Valuation Case recovery is obtained. The Plans obviate that unhappy prospect. The Valuation Case may now be conducted for the best interest of all because the securities package which is distributed to the public debt and equity holders of the Secondary Debtors confers on the holders the opportunity to benefit from a favorable result in that litigation.

The distributions provided under the Secondary Debtors' Plans are by and large uniform. The differences that do exist have been reached as a result of negotiations between the Penn Central Trustees and the Trustees of several of the Secondary Debtors. Those issues in many instances were briefed and argued to this Court before settlement was reached. I am satisfied that these individual compromises are fair and reasonable and should also be approved.

The one major issue remaining unresolved with respect to a number of the Secondary Debtors is the treatment of accrued dividends due their public stockholders. Under the Plan, the stockholders' claims are generally calculated by capitalizing, by a multiple of 10, the annual dividend and adding accrued dividends through March 31,

1976. On the other hand, bondholders of the Secondary Debtors and Penn Central have interest through December 31, 1977, included in the calculation of their claims. Thus, the respective Secondary Debtor Trustees argue that the Plan should be internally consistent. The basic methodology of quantifying the claim and the distribution for stockholders' claims, in effect, results in the stockholder being treated as a secured creditor. But the Trustees distinguish between the stockholders' claims and those of the bondholders when they use a different cutoff date in determining the amount of the claim.

There is no benchmark by which the Court can analyze the respective arguments of the parties. Cutting off the claim on March 31, 1976, is justified to the extent that the equity holders were not in fact actual creditors and by the argument of the Secondary Debtor Trustees that the leases terminated as of March 31, 1976. On the other hand, the notion of equality in treatment is appealing. For that reason, I find the Secondary Debtors' contention more persuasive. The Plan should be amended accordingly.

There remain only two relatively minor issues. The Indenture Trustee of the Connecting Mortgage has disputed the underlying Retained Asset Analysis as it pertains to the Connecting. Reorganization Library Document J-19 contains an exhibit which shows that there is an account balance of $8,000 in favor of the Connecting. The Indenture Trustee contends that that money has not been credited to the Connecting's Retained Asset Analysis and that because the account is a scrap account, it is appropriate that it be so credited. In the welter of paper which this case has generated, this isolated issue has not been adequately developed. For that reason I will reserve judgment with respect to it, and I direct that the parties

confer to see if it can be resolved amicably, and if not, to so inform the Court. Additional written submissions will permit the Court to resolve the issue forthwith. There is no reason to delay approval of the Plan pending final resolution of this matter.

The Big Four Trustee has objected to the Penn Central's debiting in the Retained Asset Analysis an amount owed by the Big Four to Penn Central under a tax allocation agreement. The objection is that it is inappropriate to debit the amount of retained assets of the Big Four by the amount of the tax allocation liability without offsetting a $175,000 pre-bankruptcy claim of a subsidiary of the Big Four against Penn Central. The objection is unsound. The basic mutual cancellation of debt compromise clearly is designed to encompass and fairly does encompass the subsidiary's claim. The tax allocation claims have uniformly been treated differently both during the course of the reorganization and in the Plan. I am satisfied that the Trustees' Retained Asset Analysis of the Big Four is correct.

Part IV

A. Consummation Date

After an Order is entered by this Court approving the Plan, the voting process will begin. At this juncture it is of course not possible to know what the result of the voting may be, or whether thereafter this Plan will be confirmed and consummated. It is nevertheless necessary at this time to address an issue which may arise if this Plan is ultimately consummated, but if the consummation date is, of necessity, postponed for one reason or another.

It is fair to state that the arguments presented at the Plan hearings were, for the most part, based upon the assumption that interest would run on all claims until December 31, 1977; that the consummation date would

be approximately July 1, 1978; and that the securities would be issued as of the consummation date. Therefore, it is reasonable to suppose that a substantial delay in the consummation date would result in some deviation from the expectations of the parties. Because cash distributions would be postponed, the reorganized company should have accumulated more cash, from interim investments. Interest on B, C, and D notes would not begin to accrue until the postponed consummation date, hence, fewer of these securities would remain outstanding by 1987. Redemptions of the D serial notes and of the A and B bonds would not be affected, so long as the timetables of the existing Plan are adhered to.

The impact of these potential variations from the expectations of the parties is somewhat lessened, of course, by the fact that any net cash benefit to the reorganized company resulting from the delay would ultimately redound to the benefit of its stockholders, primarily the secured and unsecured claimants.

I am inclined to believe that substantial delay of the consummation date should not be permitted to alter the relationships among the various classes of claimants which are reflected in the Plan. That relationship could be maintained notwithstanding a delay in the consummation date if (1) interest on B, C and D notes were calculated as beginning to run on or about July 1, 1978; (2) the redemption provisions of the D serial notes and of the A and B bonds were given effect as stated in the Plan; and (3) those claimants entitled to receive cash distributions on consummation date, and who would not benefit from any equity participation in the reorganized company, should receive some further cash participation in the additional income earned by the reorganized company from interim investments during the period of postponement. This

could perhaps be done by adding an appropriate amount of post-July 1, 1978 interest to the cash distributions on consummation date.

Of course, it must be recognized that the circumstances may be somewhat different when consummation date arrives, and it may then appear that there is legitimate need to retain the additional income from interim investments. I mention the matter at this time only so that all parties may be conscious of the uncertainties involved, and of the possible need for minor adjustments at consummation.[108]

B. Conclusions

In conformity with the views expressed in the foregoing Opinion, I now set forth this Court's conclusions with respect to the Plans of Reorganization of the Penn Central Transportation Company, and of the Secondary Debtors, as amended in conformity with the requirements of this Opinion:

1. The Plan complies with all requirements of law.

2. The Plan is feasible.

3. The Plan is fair and equitable.

Pursuant to these conclusions, when the Plan embodying the amendments required by this Opinion is filed with the Court, an Order will be entered approving the Plan and directing its submission to the voting process.[109]

108. These issues have now been substantially resolved by Order No. 3451, entered March 15, 1978. Interest on all claims runs only to December 31, 1977; interest on Series C and D notes accrues from January 1, 1978; cash distributions to secured creditors and tax claimants on the Consummation Date will include some interest.

109. The changes required have now been made. The Plan submitted for vote complies with the requirements of this Opinion and the Orders relating thereto.

Approval of this Plan marks an important milestone in the long and tortuous struggle toward a better tomorrow for the creditors and stockholders of the Penn Central Transportation Company and its affiliated companies. The Trustees and their staff, and the many other entities and individuals who have labored so long and diligently to produce this Plan are to be congratulated for their monumental achievement. Like all products of human endeavor, the Plan may not be perfect, but in my judgment it provides entirely fair and workable solutions to all of the complex and difficult problems confronting the Debtor's estate.

ORDER APPROVING THE PLAN

And Now, this 17th day of March, 1978, upon consideration of the "Amended Plan of Reorganization for Penn Central Transportation Company Dated March 17, 1978" (Doc. No. 15220), including the Plans of Reorganization of each of the Secondary Debtors therein contained (all of which are hereafter referred to, collectively, as "The Plan"), and the schedule of distribution set forth in Appendix B to Doc. No. 15221, the Court makes the following findings:

1. The Plan conforms to the requirements of this Court's Opinion dated March 9, 1978.

2. The Plan complies with § 77(b) of the Bankruptcy Act.

3. The Plan is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders with no unfair discrimination among classes of creditors or stockholders, conforms to the law regarding participation of various classes of creditors and stockholders, and complies with all of the requirements of law.

4. The Plan is feasible.

5. The Plan makes adequate provision for the payment of allowances, including compensation and reimbursement of expenses as provided in § 77 (c)(12); the amount reserved in the Plan for such purposes is in excess of the total amount of claims for such payment which can reasonably be anticipated.

Wherefore, It Is Hereby Ordered That:

1. The Plan is Approved.

2. The final date for mailing written acceptances or rejections of the Plan shall be May 12, 1978.

3. Voting on the Plan shall be governed by the provisions of the Voting Order, Order No. 3456, entered this date.

4. The provisions of § 6.2 of the Plan ("Treatment of Other Executory Contracts") shall be deemed to be without prejudice to the contentions asserted by various parties in response to the "Report of the PCTC Trustees and the Trustees of the Secondary Debtors with Respect to Prebankruptcy Executory Contracts" (Doc. No. 14122), all of which are reserved for later determination by this Court.

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor.

In re CONFIRMATION AND CONSUMMATION OF PLAN OF REORGANIZATION.

No. 70-347.

United States District Court,
E.D. Pennsylvania.

Aug. 17, 1978.

Charles A. Horsky, Brice Clagett, Washington, D.C., James E. Howard, Philadelphia, Pa., Philip Stansbury, Washington, D.C., Carl Helmetag, Jr., John J. Ehlinger, Jr., Philadelphia, Pa., for Penn Central Trustees.

Leon Leighton, New York City, for Minority Stockholders of Mahoning Coal Railroad.

David Berger, P.A., by David Berger, Philadelphia, Pa., for Penn Central Co.

Tyler & Reynolds by H. Theodore Cohen, Boston, Mass., for Charles S. Jeffrey.

Edward I. Dobin, Morrisville, Pa., for Bank of New Jersey, Indenture Trustee.

Walsh & Frisch by Jerome K. Walsh, New York City, for Certain Leased Lines.

Goodman & Ewing by Joseph J. Connolly, William H. Ewing, Philadelphia, Pa., for Certain Secondary Debtors.

Clark, Ladner, Fortenbaugh & Young by Edward C. Toole, Jr., Philadelphia, Pa., for Committee of Interline Railroads.

Sullivan & Worcester by Joseph Auerbach, Morris Raker, Boston, Mass., Gratz, Tate, Spiegel, Ervin & Ruthrauff by Spencer Ervin, Jr., Philadelphia, Pa., for New Haven Trustee.

Kelley, Drye & Warren by Stephen Green, New York City, for Manufacturers Hanover Trust Co.

Ballard, Spahr, Andrews & Ingersoll by Frederick L. Ballard, Philadelphia, Pa., for Schedule A Trustees, Girard Trust Bank.

Schnader, Harrison, Segal & Lewis by David S. Hope, Gilbert W. Oswald, Philadelphia, Pa., for Penn Central Co.

Pepper, Hamilton & Scheetz by Laurence Z. Shiekman, Teresa R. Novick, Philadelphia, Pa. for Consolidated Rail Corp.

Douglas G. Sanborn, Deputy Atty. Gen., Trenton, N.J., for State of New Jersey.

Grant G. Guthrie, Wilnetta S. Marks, Washington, D.C., for Securities & Exchange Commission.

Wolf, Block, Schorr & Solis-Cohen by Michael L. Temin, Philadelphia, Pa., for First Pennsylvania Bank N.A. as Indenture Trustee.

Reed, Smith, Shaw & McClay by Andrew N. Farley, Philadelphia, Pa., for Mellon Bank, N.A.

Shearman & Sterling by George J. Wade, Robert H. MacKinnon, Kenneth M. Kramer, Michael K. Diana, New York City, for Citibank, N.A. as Agent for the Committee of Secured Bank Creditors.

Willkie, Farr & Gallagher by Louis A. Craco, New York City, for Friday Group and Institutional Investors Penn Central Group.

Rogers & Wells by Donald F. Luke, New York City, for Committee of Interline Railroads.

John H. Broadley, U.S. Dept. of Justice, Washington, D.C., for United States.

Richards, Layton & Finger by Richard G. Elliott, Jr., Wilmington, Del., for Wilmington Trust Co., Successor Indenture Trustee.

Winthrop, Stimson, Putnam & Roberts by Stephen A. Weiner, New York City, for Irving Trust Co.

Proskauer, Rose, Goetz & Mendelsohn by Larry M. Lavinsky, Philip M. Hahn, New York City, for The Bank of New York, as Indenture Trustee.

Richard H. Stokes, Jamaica, N.Y., for Long Island Rail Road Co.

Bruce C. Fishelman, Jersey City, N.J., for City of Jersey City.

Al Blase, for various bondholders.

Dahlberg, Mallender & Gawne by J. Donald McLeod, John J. Iseman, Birmingham, Ala., for Manufacturers National Bank of Detroit, Successor Indenture Trustee.

Burgess, Fullmer, Parker, Steck & Andrews by Earl J. Krock, Cleveland, Ohio, for Kalamazoo, Allegan & Grand Rapids.

Margaret Anne Foster, Cleveland, Ohio, for Board of Education, Cleveland School District.

Dechert, Price & Rhoads by F. Hastings Griffin, Jr., Philadelphia, Pa., for National Railroad Passenger Corp.

White & Case by Robert W. Mannix, New York City, for Bankers Trust Co., Indenture Trustee.

Harvey Strickland, for Bankers Trust.

OPINION AND ORDERS RE CONFIRMATION AND CONSUMMATION OF PLAN OF REORGANIZATION

FULLAM, *District Judge.*

On March 17, 1978, this Court approved, subject to certain modifications, the Plan of Reorganization proposed by the Penn Central Trustees and separate Plans for each of the 15 Secondary Debtors [1] (the 16 Plans will be referred to as the Plan). Order No. 3279 directed that a ballot, and a copy of the Plan, this Court's Opinion, the SEC's Advisory Report and supplement thereto, and other pertinent information be distributed to the parties entitled to vote on the Plan. By overwhelming majorities, all classes of creditors, save three classes of stock of the Pittsburgh, Fort Wayne & Chicago Railroad, accepted the Plan. For example, claimants holding $1.003 billion in Class J secured claims (99.4%) voted for acceptance, while claimants holding $5.570 million (.6%) voted to reject the Plan.

A number of appeals have been taken from this Court's Approval Order,[2] briefing has been completed, and the Court of Appeals will hear oral argument some time during the week of October 16, 1978.

The two petitions before the Court (Doc. Nos. 15716 and 15931) raise four separate questions: Should the Plan be confirmed; What date should be fixed for consummation of the Plan; Are the documents pertaining to the reorganized company and its securities in proper form in all respects; What terms should be included in the Consummation Order? The parties have had an opportunity to state their positions with respect to these questions at a hearing held on July 27, 1978.

1. *In re Penn Central Trans. Co.*, 458 F. Supp. 1234 (E.D. Pa. 1978). Hereinafter cited as the *Approval Opinion.*

2. The relief requested by the principal appellants is set forth in the Appendix.

A. CONFIRMATION

1. *Objections*

Under § 77(e) of the Bankruptcy Act, a plan which has been approved by the reorganization court and has received the required favorable vote of those entitled to vote should be confirmed, unless it is established that, in the interim, circumstances have changed in such a way as to undermine the basis of the court's earlier approval of the plan. *Insurance Group Committee v. Denver, Rio Grande & Western R.R. Co.*, 329 U.S. 607, 67 S. Ct. 583, 91 L. Ed. 547 (1947). For the most part, those now objecting to confirmation of the Plan have merely restated the legal arguments previously rejected by this Court in its *Approval Opinion.* The one exception is Bankers Trust Company, as Indenture Trustee of the Consolidation Mortgage, which has, at least in a sense, asserted that circumstances have in fact changed.

Bankers Trust originally objected to the way in which the Trustees were allocating retained asset security to the various mortgages, claiming that, as a result of crediting all of the value of the Harlem properties to the reversion, rather than assigning an appropriate value to the leasehold interests of the Debtor, the Consolidation Mortgage it represented was being shortchanged. Upon further analysis, the Trustees agreed, and made adjustments which had the effect of attributing some $29 million more in retained assets to the Consolidation Mortgage. Bankers Trust thereupon withdrew its objections, and supported the Plan during the approval proceedings, but expressly reserved the right to withdraw its support, and to oppose the Plan, if the Plan as finally approved by the Court accorded to any other mortgagees better treatment than the basic 10-triple-30 treatment proposed by the Trustees for all mortgages.

As originally proposed, the Plan provided for only one class of preference stock. However, in approving the Plan, this Court directed that there be two series of preference stock, Series A and Series B, and that four designated mortgages should receive Series A preference stock, whereas all other bondholders are to receive Series B. Series A preference stock is to be redeemed before the Series B preference stock. It is this modification of the Plan in the *Approval Opinion* which Bankers Trust apparently relies upon as a "changed circumstance," justifying denial of confirmation.

Although the *Approval Opinion* does not specifically deal with the possibility that the Consolidation Mortgage should be included within the group to receive Series A preference stock, it does discuss, and reject, the argument that the Lake Shore and Michigan Central Collaterals should be included in that group; and their claims to inclusion *vis-a-vis* the Consolidation Mortgage are stronger. In other words, non-inclusion of the Consolidation Mortgage follows *a fortiori* from denial of that status to the Lake Shore & Michigan Central Collateral Mortgages.

Under the 10-triple-30 distribution scheme as originally proposed, mortgages with retained asset coverages of 100% receive the same package of securities (30% A Bonds; 30% preference stock; 30% common stock) and 10% in cash as mortgages with retained asset coverages of more than 100%. This fact led a number of Indenture Trustees to use the term "super secured" to describe the fact that their mortgages had retained asset coverages exceeding 100%. Three lines of argument were pressed by the super secureds in support of their contention that their mortgages were entitled to some form of better treatment under the Plan. The *Approval Opinion* discussed each of these arguments and rejected them.

The first argument is that because the 10-triple-30 distribution accords the same treatment to those mortgages which are secured by retained assets in excess of 100% as to those mortgages which have only 100%-retained asset coverage, the Plan is not fair and equitable, by reason of the failure to recognize the excess retained asset coverage. After a thorough analysis of the operation of the 10-triple-30 distribution scheme and consideration of an alternate distribution scheme, I concluded that even with respect to mortgages having retained asset coverage of as high as 275%, the 10-triple-30 distribution was fair and equitable.[3]

A number of super secureds which made this argument had no first liens on any retained assets. Their super secured status came about only because of the marshalling of asset values down from higher liens. This is true in the case of the Consolidation Mortgage. It has the third lien in a four-step sequential mortgage chain: First, the 013 Gold Bond Mortgage; second, the 014 Lake Shore & Michigan Central Collaterals; third, the 014 Consolidation Mortgage; and, fourth, the 015 R & I Mortgage. Any increase over the $29 million allocated by the Trustees to their leasehold interests in the Harlem would in the first instance be credited to the 013 Gold Bond Mortgage. For the purposes of considering whether the 10-triple-30 distribution is defective because it ignores retained assets in excess of 100%, it is necessary to look to first lien assets only. This is so because any other procedure results in a double count of the same retained asset values. For example, assume that there are three sequential liens each securing a claim of 100 units, and that there are 243 units

3. At the risk of over-simplifying what was a recurring theme in the *Approval Opinion*, the main reason for this conclusion is that the Plan makes possible the deferral of administration claims and has other advantages, proper allocation of which is not necessarily related to the retained-conveyed dichotomy.

of security. Lien 1 is 243% secured. If lien 2 is entitled to better treatment on the theory that it has 143 units of security then lien 1 would no longer be over-secured. If both liens got better treatment, each would be relying on the same asset values. In the context of an argument focused on the "disparities" of treatment, it is the first lien which would have the full benefit of the excess security.[4] We are dealing here in *comparisons*. If we compare two disparate piles of sand, we do not shovel sand from one pile to the other in the midst of the process. Under this analysis, the Consolidation Mortgage is in the same position as the Lake Shore Mortgage—both have zero first lien retained asset coverage. Of course, the Consolidated Mortgage is not entitled to better treatment if others with higher retained asset coverages are not.

Next, some of the super secureds argued that in liquidation their mortgages would fare better than those with 100% or less in retained asset coverage and therefore the Plan was not fair and equitable because the distribution scheme did not reflect the more favorable results on liquidation. In considering this argument, both first and second liens on retained assets were given weight and the full value of the Harlem lease was considered as at least potentially available to the Gold Bond, Lake Shore, Michigan Central, and Consolidated Mortgages. By and large, this argument was rejected because it was predicated on an over-simplified model based exclusively on "best case" assumptions. The principal liquidation scenario presented and rejected was that of the Lake Shore Collateral. It follows that the Consolidation Mortgage, which is subordinate to the Lake Shore Collateral, is in no better position.

Finally, it was argued that the equitable equivalence doctrine was violated by the 10-triple-30 distribution. The main thrust of this argument was directed to the Trustees' assumption that the estate was solvent and that unsecured and equity interests may participate. The Plan also withstood this challenge. Obviously, the Consolidation Mortgage falls within that conclusion.

It was only after consideration of these arguments that creation of two classes of preference stock was introduced. The detailed analysis of the super secureds' arguments led to the conclusion that within the class of those asserting super secured status there were such substantial differences in retained asset coverage that some form of better treatment of the most highly secureds might be appropriate. For example, the Mohawk & Malone and the Gold Bond Mortgages have first lien retained asset coverage of 275% and 243%, respectively. When this is compared with the retained asset coverage of other super secureds, for example, the Boston & Albany and the Michigan Central Collateral which have first lien retained asset coverages, respectively, of 115% and 116%, and with the retained asset coverages of the other mortgages, the magnitude of the difference is quite clear. That magnitude of the difference is relevant in and of itself, and also because the exceedingly high retained asset coverage makes it more likely there might be a sufficient cushion of retained assets to absorb administration claim assessments in liquidation. Because of the amount of the administration claims, no cushion would be provided by second lien asset values. Concededly, in drawing from the differences in retained asset coverages the conclusion that some better treatment was appropriate, the previously rejected arguments of the super secureds were in a sense partially adopted. The

4. It is essential to bear in mind that because administration expenses are under the Plan partially satisfied in cash on consummation, or shortly thereafter, the amount of retained assets available for distribution is substantially less than the total amount of retained assets subject to the liens of the respective mortgages.

question posed, however, was significantly different: Did the substantial differences in the retained asset coverages of the various mortgages justify a modification of the Plan which did not do violence to the feasibility of the Plan but at the same time made the Plan more fair and equitable. The division of the preference stock into Series A and B is a modification which meets that specification, and the Plan, in my judgment, is made more fair and equitable by the recognition of the very high percentage of retained assets of the Mohawk and the Gold Bond Mortgages.

Also included within the group of mortgages to receive Series A preference stock are two Collateral Trusts secured by the stock of the Pittsburgh & Lake Erie Railroad. The retained asset coverages of these Collateral Trusts are approximately 119% and 131%. Inclusion of these Collateral Trusts within the group to receive Series A preference stock was not based exclusively on the retained asset coverage. Rather, I also gave weight to the fact that these mortgages were secured by non-operating property. Irving Trust, the Indenture Trustee for the two Collateral Trusts, had argued that because the security was non-operating property these Collateral Trusts were entitled to treatment far superior to that accorded them by the 10-triple-30 distribution. I rejected that argument. On the other hand, in considering the secured bank settlement, weight was given to the nature of the security securing the secured bank's loan, the stock of Pennco. In the context of this Plan which incorporates a large number of compromises and seeks to avoid the ultimate litigation of a variety of complex and unanswered issues, it did not seem appropriate to recognize the potentially unique character of one creditor's security and not the others. Therefore, Irving Trust's Collateral Trusts were included within the group to receive Series A preference stock.

Again, this modification for the benefit of the collateral trusts was possible without doing violence to the Plan.

The Consolidation Mortgage's position is in no way similar to that of the Mohawk & Malone and Gold Bond Mortgages or the Collateral Trusts. Exclusion of the Consolidation Mortgage from the group of mortgages to receive Series A preference stock was *sub silentio* previously determined in the *Approval Opinion*, and as the discussion makes clear, there is no merit in Bankers Trust's objection to confirmation.

There is another objection which warrants mention. Penn Central Company, the owner of the Debtor's stock, supported the Plan during the approval hearings and voted in favor of the Plan. Under the Plan, Penn Central Company receives 10% of the reorganized company's new common stock. In connection with the hearing on confirmation, Penn Central Company supported confirmation and advocated prompt consummation as in the best interests of the shareholders of Penn Central Company.

Joseph Shaffer, a shareholder of Penn Central Company purporting to act for eight other shareholders who own 147,600 of the 24 million outstanding shares of Penn Central Company, appeared at the hearing and opposed confirmation and consummation of the Plan. Shaffer submitted an affidavit and a copy of his brief on appeal to the Third Circuit. On the same day as the confirmation hearing before this Court, Shaffer initiated proceedings before the Bankruptcy Court presiding over Penn Central Company's Chapter XI proceedings seeking to have the previously entered Order of that Court authorizing an affirmative vote on the Plan set aside. A hearing on Penn Central Company's Motion to Dismiss the proceedings in the Chapter XI court is scheduled a few weeks hence.

Shaffer's strategy appears to be carefully conceived. Ordinarily, this Court would have no jurisdiction to col-

laterally review an order of the Chapter XI court. On the other hand, the Chapter XI court's Order was entered on April 21, 1978, and no appeal was taken. Now the argument appears to be that this case must come to a standstill until Shaffer's Chapter XI litigation is completed. The simple answer is, however, that Penn Central Company's vote was authorized by the Chapter XI court and this Court accepts that vote as valid.

Apparently, Shaffer also objects to confirmation of the Plan on the ground that it is not fair and equitable to Penn Central Company. No attempt has been made to suggest that there are any changed circumstances supporting Shaffer's contention. Rather, the objection is simply that the distribution to Penn Central Company is inadequate. Shaffer's objection to confirmation must be denied for two reasons: (1) he is not a shareholder of the Debtor as required by § 77(c)(13); and (2) there are no changed circumstances warranting reconsideration of the treatment of the Debtor's stock under the Plan.

In the interests of clarity, it should be noted that Shaffer's complaints are permeated by misconceptions of the role of this Court and the realities of these proceedings. The Penn Central Company's Chapter XI plan is not and never has been before this Court. Therefore, the amount of the reorganized company's stock which is to be distributed pursuant to the Chapter XI plan of Penn Central Company in exchange for Penn Central Company shares is not within this Court's purview. The evils allegedly committed by the United States Government are not curable in this Court or through the Plan of Reorganization. The RRRA is constitutional and implementation of that statute is a matter for the Special Court. When these two aspects of Shaffer's submission are excised, the only remaining point is that if the Trustees obtain a *Valuation Case* judgment of $11 billion, or some other amount of

that magnitude, the creditors who are giving up debt claims in exchange for common stock will receive a windfall.

The $11 billion figure is taken from a letter authored by an attorney on the SEC staff who stated that the range of *Valuation Case* recoveries is $500 million to $11 billion. The Special Court's Opinions to date were extensively described in the *Approval Opinion* because they constituted part of the relevant context in which the Plan must be considered. The valuation theories which would generate a *Valuation Case* award approaching $11 billion have been resoundingly rejected by the Special Court.

> "We should also advise the parties, in interest of their avoiding the expense incident to complex engineering studies, that we do not intend to consider estimates of reproduction costs, variations on that theme such as 'assemblage value,' value of materials 'in place,' trended original costs, gross liquidation value or societal values." *In re Valuation Proceedings under ,§ 303(c) and 303 of the Regional Rail Reorganization Act of 1973* (445 F. Supp. 994, 1031 (Special Ct. 1977).

The valuation theories adopted by the Special Court would seem to rule out any prospect of a "windfall" recovery.

I pointed out in the *Approval Opinion* that "the immediate issue is whether the risks, uncertainties and possible benefits of the *Valuation Case* litigation, and the consequences of the RRRA process, are being fairly apportioned in the distributions proposed in the Plan." [5] The answer I gave was that "the allocations are fair and equitable." The correctness of that answer is demonstrated by considering what Penn Central Company's position

5. *Approval Opinion*, 458 F. Supp. at 1346.

would be in the absence of the Plan. The debt claims against the estate far exceed the value of the retained assets. Therefore, the Debtor's stock interests could receive at most only some form of contingent claim against the *Valuation Case* recovery. But if Penn Central Company received only a contingent claim, its stock would be worth pennies for many years to come. When the results of the *Valuation Case* became known, there would be some value to Penn Central Company's stock if, but only if, the recovery was high enough to pay off all other claimants. In contrast, under the Plan, Penn Central Company receives 10% of the common stock of the reorganized company and thereby receives 10% of the value of the ongoing business operations of the reorganized company and the potential increments in that value. Thus, in lieu of waiting a decade in which the Penn Central Company's stock would be worth little or nothing, the stockholders of Penn Central Company will own stock which has value. If they wish, they may still await the outcome of the *Valuation Case,* but they now have other choices as well.

The Plan and the compromises which support it also provide other benefits to Penn Central Company. The certificates of value which are issued by the United States bear interest at 8% compounded annually from April 1, 1976. But, under the Plan, interest on claims, as well as on the new securities, is handled quite differently. (1) The D Notes issued to taxing authorities will bear a 7% interest rate. (2) In calculating the amount of secured creditors' accrued interest, interest accruals between April 1, 1976, and December 31, 1977, were booked at the contract rate applied only to principal, and the A and B Bonds, which are exchanged for 30% of the secured claimants' claims, bear no interest between January 1, 1978, and April 1, 1981, but thereafter accrue interest at 7%

compounded semi-annually to the extent not paid. (3) Sixty percent of the secured claimants' claims are paid in non-interest-bearing securities, preference and common stock. (4) Most unsecured creditors receive no interest at all for the post-reorganization period and the Plan securities issued to unsecured creditors are non-interest-bearing.

The benefit of these aspects of the Plan to the Penn Central Company lies in the fact that all securities ahead of the reorganized company's common stock will be redeemed if the *Valuation Case* base award is approximately $887 million.[6] Any base award in excess of that amount will directly benefit equity and in particular Penn Central Company as a holder of 10% of the reorganized company's common stock. A much different situation would occur in the absence of the Plan. Under the absolute priority rule, it would appear appropriate to accord claimants, secured and unsecured, the benefit of the 8% interest rate on the certificates of value. That interest accrues on the *Valuation Case* award because of the delay in receipt of the award. The parties who suffer from that delay should as a matter of fairness be accorded the benefit of the Government's payment. The impact of such an analysis is substantial. Penn Central Company's contingent claims on the *Valuation Case* proceeds would be subordinated to a vastly increased amount of claims. By way of illustration, if only the amount of claims satisfied by preference stock and common stock is assumed to be satisfied by a debt security issued as of January 1, 1978, with an 8%

6. Add to the $797.1 million shown in the *Approval Opinion* (458 F. Supp. at 1346) the additional amount of 1976 base award, $90.26 million, necessary to meet the C-1, C-2, and D Notes to be issued as the result of recently approved settlements with Amtrak, ConRail, Six Month Creditors, and the State of New York. Included in the calculation is the cost of servicing the D Notes on a current basis.

interest rate compounded annually, the *Valuation Case* awaru necessary to satisfy outstanding securities is increased from \$887 million to \$2,148.6 million.[7] Of course, under the Plan, Penn Central Company begins to participate at a 10% rate if the *Valuation Case* recovery reaches \$887 million, and therefore a *Valuation Case* base recovery of \$2,148.6 million would result in Penn Central Company indirectly receiving \$126 million of the base award in excess of \$887 million. Converted to 1987 dollars, this is about \$311 million. On the other hand, if there were no Plan, the same base award would generate zero recovery to the Penn Central Company.

It should be noted that the figures used in the preceding analysis are subject to criticism because by hypothetically converting the preference and common stock to debt securities Pennco's asset values would be freed up. On the other hand, a substantial portion of Pennco's value would be absorbed by completing the analysis and according the 8% interest rate to all claims post-April 1, 1976, and all securities issued under the Plan. Moreover, because the debt securities would have a downside risk but no upside gain, it might be appropriate to view any remaining portion of Pennco's asset values as fairly allocable to holders of the converted preference and common stock. The illustration is not intended to assert exact figures or

7. From Page 160 of the Amended Plan take the amount of claims secured creditors give up in exchange for preference and common stock, and add that amount, \$1,134 million, to the amount of unsecured claims shown on Page 132, \$701.1 million, and then subtract \$30 million to reflect the Six Month Creditors' settlement to give a total of \$1,805.1 million. Calculate the future value of that amount 10 years hence at 8% interest compounded annually. The future value of \$3,897.1 million is then converted to a 1976 base award of \$1,577.6 million. Next, the \$887 million (fn. 6, *supra.*) must be adjusted by eliminating the amount contained therein, \$316 million, to satisfy preference stock and CBI, to yield \$571 million. The \$571 million and the \$1,577.6 million are added to give a total of \$2,148.6 million.

the precise legal consequences, but merely to demonstrate in a general way the very concrete benefits of the Plan to Penn Central Company.

In sum, while sympathetic to the protestations of Mr. Shaffer and the frustrations which are associated with the complexity of the various proceedings in this Court, the Chapter XI court, and the Special Court, I remain convinced that the Plan's treatment of the Debtor's stock interest is fair and equitable.

2. *Cramdown*

Section 77(e) empowers the Reorganization Court to confirm a Plan even if a class rejects the Plan. The Pittsburgh, Fort Wayne & Chicago Railway Company Plan was submitted to four classes of stockholders for vote. None of the 7% original guaranteed stock or the 7% special guaranteed stock was voted. The vote of the common stock, 52.5% in favor of the Plan and 47.5% against the Plan, was below the required two-thirds majority. Notwithstanding these results, the Court finds that the prerequisite conditions of cramdown as specified in § 77(e) are satisfied and the Pittsburgh, Fort Wayne & Chicago Railway Company Plan will be confirmed.

As previously discussed in connection with the objections to confirmation, Penn Central Company voted all of the Debtor's stock in favor of the Plan. When Mr. Shaffer's efforts to annul that vote were described at the hearing on confirmation, the Trustees suggested that the Court might as a precaution consider exercising the § 77(e) cramdown power. I am satisfied that the exercise of the cramdown power would be appropriate and I would exercise that authority if the procedural posture so warranted. The Penn Central Company's vote in favor of the Plan must be considered valid at this point and there is no real utility in formally exercising the cramdown authority.

B. Consummation Date

A very important issue which the Court must now decide is whether to permit consummation to go forward notwithstanding the pendency of appeals from the Order approving the Plan, and the probability that those same appellants will appeal from the Confirmation Order and Consummation Order. Not surprisingly, in their written submissions the supporters of the Plan stress the need for prompt consummation while the appellants argue for delay. In their petition the Trustees have suggested that even if the Plan is consummated immediately, adequate provision could be made in the Consummation Order to protect the interest of appellants. At the hearing, the Trustees presented a specific additional provision to the Consummation Order, ¶ 7.7, which reserves jurisdiction in the Reorganization Court to order, after consummation, the payment of cash and the issuance of securities of the reorganized company in amounts necessary to accord to the appellants the full benefit of any success they may achieve in the Court of Appeals. (The indentures and other documents would be amended to bring the documents into conformity with the Trustees' proposal.)

Supporters of the Plan have reiterated their position that the Plan should be consummated forthwith. The Securities and Exchange Commission has also advocated prompt consummation as the course most consistent with the interests of the public security holders who have accepted the Plan and who are to receive cash and securities on consummation.

Some of the appellants are satisfied with the Trustees' proposal (Irving Trust and Bankers Trust). Others suggest that the Confirmation Order should be entered, but immediately stayed, either until the appeals are decided (Manufacturers Bank of Detroit), or until November 15,

subject to reconsideration at that time (Wilmington Trust). One appellant (Bank of New York) is satisfied with the Trustees' proposal only if the additional A Bonds it seeks on appeal are actually reserved and set aside on consummation date. Wilmington Trust and Manufacturers National Bank of Detroit also urge that, if their requests to delay consummation are not honored, the securities they seek on appeal should be set aside.

I shall now briefly review the factors which must be considered in arriving at a decision.

The need for prompt consummation is indeed very great. The major compromises upon which the Plan depends are conditioned upon actual consummation of the Plan this year, as are the further settlements recently approved. As a practical matter, therefore, the situation must be regarded as presenting a choice between prompt consummation or the possibility that there will be no Plan in the foreseeable future.

Of almost equal importance is the desirability of having the reorganized company established and operating, under the control of its board of directors, as soon as possible. This is essential for efficient planning in any event, but is particularly vital here because of the importance of obtaining the benefit of the debtor's huge tax-loss carry-forwards. Unless consummation occurs well in advance of the end of this calendar year, there is a substantial likelihood that some of these benefits might be lost.[8]

8. The 1979 income of the reorganized company will be sheltered, but additional 1979 income of about $224 million can be sheltered, if sources can be acquired. While it would theoretically be possible to obtain the full benefit by corporate action late in 1979, the likelihood of achieving that result diminishes with each day after January 1, 1979. Only the Board of Directors of the reorganized company can plan and carry out the negotiations leading to the required transactions; no serious negotiations can occur until its corporate existence commences; and a great deal of lead-time is required.

In short, delay in consummation involves grave risks, which cannot, as a practical matter, be guarded against by the posting of security as a condition of stay.

Apart from these compelling reasons, equitable considerations militate against further delaying distributions to the overwhelming majority of creditors satisfied with the Plan, merely because the Indenture Trustees of a handful of issues and a relatively few individual creditors seek better treatment than the Plan provides.

Having thus summarized the important reasons for prompt consummation, it is necessary to refer to other factors which must be taken into account. It is, of course, extremely important to avoid prejudicing the appellate rights of the appellants. This Court should take no action which could reasonably be interpreted as an attempt to moot the appeals, or to deprive the appellants of the fruits of any victory they may achieve at the appellate level. A more subtle but equally important point is that the Court must take no action which could be interpreted as attempting to control the timing of appellate decision, or as interfering with the Court of Appeals' determination as to when and how the appeals should be decided.

And finally, I believe it is desirable, if at all possible, to reduce the need for burdening the Court of Appeals with interim applications for stays, and to increase the likelihood that any applications which may be presented to the Court of Appeals will not need to be acted upon until the appeals themselves have been argued.

The remaining task of this Court is to determine how these various competing considerations can best be accommodated.

Most of the appeals originally taken from the Approval Order have been withdrawn. Although the reasons the remaining appellants advance in support of the relief requested pose fundamental challenges to the theoretical

basis of the Plan, with one exception the adjustments they seek are limited in scope. Even if each appellant were to be fully successful on appeal the feasibility of the Plan would not be jeopardized. Complete success on appeal would result in a reduction in the amount of B Bonds, Preference Stock, and Common Stock to be issued and a substantial increase in the amount of A Bonds to be issued. Notwithstanding this increase in the total amount of A Bonds issued, only a modest amount, if any, of A Bonds would remain unsatisfied in 1987.[9] A *Valuation Case* base recovery of approximately $594 million would fully satisfy the A Bonds outstanding.[10] Any A Bonds not satisfied from *Valuation Case* proceeds would be payable over ten years in equal annual installments with accrued interest. It cannot fairly be contended, and indeed no one has asserted, that potential debt of this magnitude renders the Plan not feasible.

The issuance of any new A Bonds to satisfy the appellants would have serious ramifications for other creditors, in that it would decrease the likelihood of early redemption of A and B Bonds, and increase the likelihood that some of their debt securities would be converted to

9. The Appendix to this Opinion is an attempt to calculate, subject to the assumptions stated, how the issuance of more A Bonds would work out. The estimated A Bond overhang of $46.08 million may or may not prove correct. An 8.6% increase in the forecasted ADP proceeds for 1978 through 1983 would completely cover the overhang. Moreover, even if a much smaller percentage increment in ADP proceeds was obtained, if the increment was in the early years, the overhang would be eliminated because interest costs, which begin in April of 1981, would be avoided. There is also the possibility that some of the estimates of payments and the reserves will prove too high or unnecessary.

10. *Valuation Case* award necessary to pay all Notes $398.3 million, (*Approval Opinion,* 458 F. Supp. at 1346), plus the base award to cover the settlements (fn. 6 supra), $90.26 million, plus the base award to cover B Bond principal and interest (see Appendix) $86.5 million, plus the base award to cover the oustanding A Bonds, $18.65 million.

equity. The adverse impact upon other participants, while serious, would be precisely the same, whether consummation occurred before or after the appeals were decided. Notwithstanding this potential impact and the possibility that the Court of Appeals might adopt reasoning which would, if implemented throughout the Plan, result in better treatment to the holders of bonds for which no appeal has been taken, no non-appellant has objected to immediate consummation. That being so, the remaining question is whether or not the Trustees' proposal adequately protects the interest of the appellants.

In my judgment the Trustees' proposal for a comprehensive reservation of jurisdiction is more than adequate. It guarantees to the appellants that to the extent that they are successful this Court will have reserved jurisdiction to direct the payment of cash or the issuance of securities adequate to comply with any appellate mandate or to implement any appellate decision on remand. I see no purpose in specifying amounts of A Bonds or cash to be reserved as requested by some of the appellants. It is theoretically possible that on a given day in 1979 or 1980 there would not be cash on hand to satisfy what the appellate process found the appellants were entitled to. On the other hand, the forecasted asset disposition proceeds from now through 1980 is so great that cash would shortly become available. Issuance of additional securities poses little problem.

The one exception to the foregoing comments is the appeal which has been filed on behalf of a small number of stockholders of Penn Central Company, the Debtor's sole stockholder. These appellants contend that the Approval Order should be vacated in its entirety, and that reorganization of the Debtor should await the outcome of the *Valuation Case*. For the reasons stated in connection with their objections to the confirmation, their standing in these proceedings is so dubious, and the merits of their arguments so tenuous, that the pendency of their appeal plainly does not justify delaying consummation.

Having considered all of the foregoing factors, I have concluded that the consummation date should be fixed for October 24, 1978.

The next question is whether any distributions should be made to the bondholders under mortgages for which Indenture Trustees have taken appeals. The Trustees have proposed a procedure which has much to commend it. Holders of bonds for which an appeal has been taken would have the option of accepting the distributions specified in the Plan and foregoing the right to any benefits which might accrue from the appeal, or waiting until the appeal was decided and then receiving a distribution which was consistent with the results on appeal. Presumably, this choice would be exercised only after disclosure satisfactory to the Trustees, the appealing Indenture Trustees, and the Court. Individuals who voted in favor of the Plan would have the option to stick by their original judgment. The drawback is that persons holding identical bonds would receive different treatment under the same Reorganization Plan. Yet, I am quite certain that if the bondholders were given the choice of waiting until the appellate process is concluded or accepting the distributions as specified in the Plan, a great many would accept Plan distribution and execute releases of any rights on appeal.

An alternative to this procedure would be to distribute to all pursuant to the Plan on consummation date, but if any of the appeals are sustained, the securities to be replaced would be called in exchange for the new securities. For example, if it were found that a particular bond issue was entitled to Series A Preference Stock in-

stead of Series B Preference Stock, the Series B would be called and the Series A would be issued. While this approach appears relatively easy because all the reorganized company's securities will be in registered form, it ignores the large number of bondholders involved, the fact that most of the bonds are now in bearer form, and the substantial burdens of the issuance and recall process. There is also an appearance of unfairness in that the bondholders have the best of both worlds. On the other hand, this Court has previously decided that they are entitled to that which is provided in the Plan, and giving it to them now seems entirely fair. The final alternative is simply to withhold distribution to the bondholders under any mortgage for which the Indenture Trustee has taken an appeal. Since at least some of the Indenture Trustees have asked that the consummation be stayed, it seems somewhat anomalous that they would object to having that relief granted in partial form.

There is no clear balance in favor of any of the alternatives. I am concerned that the situation be as clear as possible to the public at large, and that money and time not be wasted by having two distributions when one would suffice. My conclusion is that the best approach is to withhold all the distributions to bondholders under the mortgages for which the Indenture Trustees have taken appeals until December 15, 1978.

Before that date arrives, counsel will have an opportunity to be heard with respect to whether or not the distribution should be withheld for some short additional period. Pending an order authorizing distribution, cash due under the Plan to the bondholders under mortgages for which appeals have been taken will be escrowed in an interest bearing account. Any interest earned on the account after the date on which any other class J creditor receives his distribution from an exchange agent will be

added on a pro rata basis to the cash distributions which are later made. As for the securities, they will be issued but not distributed. If the appellate process is concluded in time to permit distribution shortly after December 15, 1978, no additional problems will arise. In the event there is no such distribution, then an accommodation would have to be made to take account of the December 31, 1978 redemption of A Bonds. This redemption is forecasted at $169 million. The total A Bonds under the mortgages for which appeals are pending constitute 17.79% of all A Bonds to be issued under the Plan. Therefore, that percentage of ADP proceeds will have to be set aside for later application when distributions are made. I recognize that it can be argued that a slightly different procedure should be followed. If the maximum amount of A Bonds which may be required if all the appeals are successful is taken account of, the set aside percentage increases to 32%. I do not mean to foreclose that result. Counsel will have an opportunity to express themselves on that point in connection with the hearing which will be held to determine what happens after December 15, 1978.

C. Objections to the Consummation Documents

The consummation documents (the amended charter and new bylaws of the reorganized company, the forms of the securities and the indentures under which the securities will be issued, and related documents) have been submitted to the parties for review and comment. Most of the suggestions of the parties are now incorporated in the revised versions of the documents which are before the Court for approval. Considering the complexity of the Plan, the fact that such a small number of disputes remain is a tribute to the draftsmen.

In conformity with Section 4.3 of the Plan, both the A and B Bond Indentures provide that redemption is by

lot until December 31, 1987. Thereafter, redemption is pro rata. Holders of $100,000 of either A or B Bonds are, however, permitted to elect pro rata redemption in lieu of redemption by lot. Many of the Indenture Trustees [11] and two of the secondary Debtor Trustees, Messrs. Kohl and Leary, have vigorously contended that all redemptions should be pro rata. The Securities and Exchange Commission while generally satisfied with the redemption method specified in the Plan and Indentures suggests that if there is to be a change in the redemption scheme it should be to make all redemptions by lot.

There are two aspects to the problem. First, there is the flavor of a preference for those who will hold $100,000 or more of either issue. In the circumstances, however, this is not very troubling. The administrative complexities of implementing pro rata redemption of the bonds held by a relatively small number of persons are substantially less than the complexities of an across-the-board pro rata redemption scheme. Second, there is a possibility that some B bondholders will have the full amount of their bonds redeemed but others will have their bonds converted to common stock. If the appellants from the Approval Order are not successful on appeal, there will, in all likelihood, be one B Bond redemption. Approximately $25 million in B Bonds are forecasted to be redeemed in 1983. Redemption of the balance of the B Bonds depends upon the amount of the *Valuation Case* recovery. If the recovery is $488.55 million, there will not be any redemption of the outstanding B Bonds, whereas the full outstanding balance of the B Bonds, including interest, will be satisfied with a *Valuation Case* recovery of $571.21 million.[12] Assuming a recovery between these two amounts, for example, $527.88 million, and that the *Valuation Case* proceeds are received before the pro rata redemption provision applies, half of the B Bonds will be fully paid and the balance will be converted to common stock. Although the by lot redemption scheme is fair in the abstract, a pro rata redemption scheme would be preferable in these circumstances.

The A Bonds are somewhat different. If none, or only $20 to $30 million in additional A Bonds are issued as the result of the appellate process, all the A Bonds will, in all probability, be redeemed by 1983. The consequence of being at the bottom of the redemption list is merely a brief delay in payment. Moreover, the 7% interest begins to accrue on April 1, 1981. Even if the result shown in the Appendix occurs, there would be $46 million in A Bonds outstanding, assuming the *Valuation Case* proceeds were not adequate to retire them, but the A Bond debt would be hard debt of the reorganized company and there is every reason to believe that it would be refinanced or paid pursuant to the extension provisions of the Plan. Therefore, the A Bond indenture is generally satisfactory.

Changing the B Bond redemption scheme is desirable, but there are some obstacles to consider. First, there is some question as to whether the bonds could be listed on national exchanges if there is pro rata redemption. Second, even if listed, once the bonds are reduced by partial redemption below $1,000 or to a number between any two multiples of $1,000, the bonds would no longer be marketable. The Securities and Exchange Commission concurs in this view. Giving up marketability, particularly as of the date of issuance, would be extremely unfortunate. One partial solution to the B Bond problem is to have redemptions from ADP proceeds occur by lot, but permit pro rata redemptions from *Valuation Case* proceeds. If this ap-

11. The Objecting Indenture Trustees are listed in Document No. 15885, as amended. The Objecting Indenture Trustees will be referred to as the "Indenture Trustees."

12. This example is oversimplified because all accrued interest is paid before there is any redemption.

proach is adopted, whenever *Valuation Case* proceeds became available for redemption of B Bonds the whole issue would be called. The problem is that it is possible there will be *Valuation Case* proceeds available to redeem only a portion of the B Bonds outstanding and there will also be unliquidated *Valuation Case* securities which might not be liquidated for some months or years after the *Valuation Case* proceeds were distributed to B bondholders. Therefore, if the B Bond issue were called, there would have to be a mechanism for later distributing the proceeds from liquidation of the *Valuation Case* securities. Moreover, there is always the possibility of a Tucker Act action in the Court of Claims which might not be concluded until substantially after the receipt of *Valuation Case* proceeds.[13]

There is ample time to work on the problem and therefore, I will reserve judgment on the issue. The Trustees are directed to examine the problem and the Court's expression of concern to determine what changes can be made without resulting in the denial of listing on the exchanges. Moreover, the Trustees should address the question of whether or not any changes which are suitable for the B Bonds are also appropriate for the A Bonds. The Trustees will be required to file their report on this subject and serve it on the parties no later than September 5, 1978.

The A and B Bond Indentures, as well as other indentures, contain a covenant that the Company shall prosecute the *Valuation Case* in such manner as its Board of Directors determines "to be in the best interests of the Company." It is suggested by some of the Indenture Trustees that the following be substituted: "prosecute the *Valuation Case* in such manner as the Board of Directors determines will maximize the *Valuation Case* proceeds,"

13. Of course, none of this will occur if the *Valuation Case* result is approximately $571.21 million or more.

but the Company shall not be required "to expend more time or money on the prosecution of the *Valuation Case* than would reasonably be expended by a claimant entitled to all the *Valuation Case* proceeds." Although the proposed amendment seems merely an explicit statement of what was the intent of the covenant now in the Indentures, the Trustees have opposed the amendment on the ground that it would inhibit settlement of the *Valuation Case* because "Directors might well fear the difficulty of proving, in the face of a dispute, that better results would not have been obtainable through litigation." The fear expressed by the Trustees is clearly unwarranted. The amendment would fully accommodate a settlement of the *Valuation Case*. In light of the delicate nature of the relationships between the various securities the amended version is preferable. It should be included in each of the Indentures which contains this covenant.

A minor objection is that although the granting clauses of the Series A and B Bond Indentures are stated in extremely broad language, the granting clauses do not contain the term "security interest" as that term is understood under the Uniform Commercial Code. There is no harm in including that term in the granting clauses, and, therefore, the Trustees will be directed to include that term. The other objections made by the Indenture Trustees are without merit.

The State of New Jersey seeks a new covenant in the C Note Indenture precluding the reorganized company from incurring liabilities other than in the ordinary course of business, and in the D Note Indenture, a lien on all after acquired property of the reorganized company and certain protective covenants which have been given to the Series A and B Bonds. Clearly, each of the requested changes would enhance the position of the State. None

of the changes are, however, required under the Plan and I do not believe they are necessary. Moreover, to some extent the changes are predicated upon a myopic view of the interrelationship of the various securities. For example, none of the debt securities to be issued under the Plan will have a lien on after acquired property. To accord such a lien to the D Notes would constitute an unnecessary restraint on the conduct of the affairs of the reorganized company. The activities which might be inhibited are those which in the long run might well benefit those claimants who will receive common stock under the Plan. In sum, I find that New Jersey's request for changes in the C and D Note Indentures are not required by the Plan and are not necessary to accord the State adequate protection.

D. Objections to the Consummation Order

The Trustees have presented a comprehensive Consummation Order and Final Decree. Numerous objections were filed in response to the Trustees' petition, but many have been withdrawn or mooted by proposed changes in the Order. Except as herein specified, I have concluded that the objections are without merit.

The State of New Jersey and the Cleveland Board of Education have raised issues which pertain equally to all taxing authorities. Under the Plan an interest payment on the Series D Notes was due on June 31, 1978. The proposed Order contemplates distribution of that interest payment with the Notes themselves. Considered against the background of the taxing authorities' initial opposition but later support of the Plan, and the fact that the taxing authorities will receive no equity-type securities, it is appropriate to require that in addition to the D Note interest payment the Trustees shall also pay interest on that amount

until the consummation date calculated at the same rate as that specified in § 5.5 of the Plan. This adjustment brings the treatment of the D Note interest payment into conformity with the provisions for interest to be paid on the cash payments due taxing authorities.

The process of distributing to the taxing authorities involves a number of steps. First the Trustees are to inform the taxing authority of the amount that they believe is owed, and thereafter the taxing authority is to execute a release and return it to the Trustees or the reorganized company. Then, the Exchange Agent is to be informed by the reorganized company as to the payee, and the distribution is to be mailed out by the Exchange Agent. On the whole, this process appears to be calculated to serve the best interests of the estate without unduly delaying a distribution to the taxing authorities. It must be remembered that the overall process of making distributions under the Plan will be monumental in scope. I do believe, however, that the taxing authorities and the public they serve are entitled to get the fastest service feasible. To that end, the Trustees are directed to use their best efforts to send all notices of the amount owed before September 20, 1978 and to be able to notify the Exchange Agent of the amounts due no later than October 20, 1978, provided that the Trustees receive the taxing authority's release on or before October 11, 1978. The releases should also indicate that taxing authorities have the option of picking up their distributions from the Exchange Agent rather than having them mailed out. The mechanics of that election and the safeguards that may be necessary should be a simple matter for the Trustees to work out.

New Jersey's request that the E Note Indenture be submitted to the Court for approval is also reasonable. While it is not at all clear that the taxing authorities have

a valid basis for requesting that the A Note Indenture also be submitted to the Court for approval, I believe both Indentures should be submitted to the Court for approval so that the parties will have an opportunity to determine whether or not the Indentures conform to the Plan. It is not necessary that this be accomplished immediately because it is not anticipated that A Notes will be issued, and if any are issued it will not be for several years, and the E Notes cannot be issued until after the conclusion of the *Valuation Case*. Therefore, the Trustees, and their successor, the reorganized company, will be directed to submit the A and E Note Indentures no later than April 1, 1979. If a hearing is required, the hearing date will be set shortly thereafter.

There is one oversight in § 403(iii) which should be remedied. A creditor who has liquidated all his unsecured claims but who is a party to an executory contract which has now been disaffirmed should be able to receive his distribution on the liquidated unsecured claim even though the claim arising from the rejection of the executory contract has not yet been liquidated.

The non-bankrupt leased lines filed a great many objections to the Consummation Order. The Order has been slightly refined and counsel for the Trustee has stated on the record (Transcript 18,527-28) an interpretation of the reservation of jurisdiction which meets, in my judgment, the essence of the objections. After the consummation of the Plan, claims of the non-bankrupt leased lines may be litigated before this Court, and if liability is found, the claim will be classified and the distribution fixed accordingly. However, if the Court finds that for some reason the distribution as specified under the particular classification is not fair and equitable for the non-bankrupt leased line some other form of satisfaction of the claim

may be ordered by the Court. That being the case, the non-bankrupt leased line interests are fully protected. Moreover, the amount of the potential leased line claims is relatively modest, and there is no need to establish escrow arrangements to protect their interests. Distributions ordered by the Court can and will be satisfied forthwith.

E. The Role of the Board of the Reorganized Company

A perusal of the corporate documents involved in the consummation of the Plan underscores the intricate and delicate relationship between the various creditor interests in the Penn Central estate. On the whole, of course, their interests coincide: the success of Pennco as an ongoing business; development by the reorganized company of other corporate activities which maximize the benefits of its tax-loss carry-forwards and constitute sound ongoing business operations; and the successful prosecution of the *Valuation Case*. There are, however, some situations in which the Board of Directors of the Company will find it necessary to make decisions which will affect one class of owners somewhat differently from the others. This is an unusual situation for a board to confront, but it arises because of the complexities of the capital structure of the reorganized company. There is no reason to suppose that the Board will not be equal to the task.

I reiterate the view expressed in the *Approval Opinion*, namely, that the parties and their counsel are to be congratulated for a job well done.

APPENDIX

A. *Relief Sought on Appeal*

(Source: Trustees' Memorandum (Doc. No. 16107))

Wilmington Trust, as Indenture Trustee of the Michigan Central Collateral	$6.5 million in Series B Preference and $6.5 million in common stock replaced by $13 million in cash and A Bonds; or, in the alternative, Series A Preference for Series B Preference
Bank of New York, as Indenture Trustee of the R&I Mortgage	$43.8 million in B Bonds replaced by $43.8 million in A Bonds
Manu. Nat'l Bank of Detroit, as Indenture Trustee of Lake Shore Collateral	$5.9 million in Series B Preference stock replaced by $5.9 million in A Bonds
Bankers Trust, as Indenture Trustee of Consolidation Mortgage	$24.8 million in Series B Preference stock replaced by $24.8 million in Series A Preference stock
Irving Trust, as Indenture Trustee of Mohawk & Malone mortgage	$590 million of A Bonds, and like amounts of Series A Preference and common replaced by $1.777 million in cash
Irving Trust, as Indenture Trustee of NYC 6% Collateral Trust and P.C. 6½% Bonds	Reorganized company assumes total obligation, $15.481 million, and leaves P&LE stock pledged, or distributes stock in full satisfaction

B. *Method of Quantification*

An appellate award of cash would have the effect of reducing ADP proceeds available to redeem new securities. An award of A Bonds would increase the amount of A Bonds to be satisfied. The net effect of either would be upon the redemption of A Bonds. For convenience, it will be assumed that only additional A Bonds would be required to be issued.

If the P&LE stock either remains subject to pledge or is distributed, the forecasted ADP proceeds in 1983 would be reduced. The net impact on redemption would be the same as awarding A Bonds.

Based on (A) above, and the method stated herein, the maximum increase in A Bonds would be $79.36 million.[x]

C. *Relief with No Impact Except Upon Other Claimants*

Substitution of $24.8 million in Series A Preference stock allocated to the Consolidated Mortgage for $24.8 million of Series B Preference stock would dilute the benefit of the Series A Preference stock to the four bond issues which are to receive Series A Preference stock and increase the amount of the Series A which is prior to Series B Preference stock.

D. *Impact on Redemption*

1. ADP proceeds satisfy securities prior to A and B Bonds first. Thereafter, ADP proceeds are applied to A Bond interest, A Bond principal, B Bond interest, and B Bond principal, in that order.

x. The $1.777 in additional cash sought by the Mohawk & Malone replaces, in part, $.590 in A Bonds. Thus, the total only includes $1.18 million to cover substitution for Series A Preference stock and common stock.

2. Beginning with the "Revised Eleven-Year Cash Flow Projections" (Doc. No. 14434), determine the effect of issuing $79.36 million in additional A Bonds.

3. Principal of A Bonds outstanding on December 31, 1980, is $39.3 million ($344.2 million less $304.9 million redeemed). Add $79.36 million in A Bonds for a total of $118.6 million.

4. Apply cash flow to the $118.6 million.

1981	Int. 2d quarter	$ 2.075
	Int. 2d half	4.150
		6.225
	ADP	9.3
	Available for A Bond Prin.	$ 3.075
1982	(A Bond prin. $115.5)	
	Int. 1st half	$ 4.042
	Int. 2d half	4.042
		8.084
	ADP	21.9
	Available for A Bond prin.	$13.82
1983	(A Bond prin. $101.68)	
	Int. 1st half	3.55
	Int. 2d half	3.55
		7.10
	ADP	62.7
	Available for A Bond prin.	55.6
1984	(A Bond prin. $46.08)	
	Int. 1st half	1.61
	Int. 2d half	1.61
		$ 3.22

5. In 1984 and thereafter the accruing interest would be $3.22 million per annum. The B Bond interest payment shown in the cash forecast is from Pennco dividends. Presumably, the A Bond interest would be satisfied from Pennco dividends.

6. Net result, $46.08 million in A Bonds outstanding as of 1987, with no interest due.

7. Reduce the $223.1 in B Bonds shown on the cash flow by $43.8 million, so that the amount issued would be $179.3.

8. The B Bond interest payments in 1981 and 1982 would not be affected by the additional A Bonds. In 1983, there would be no B Bond interest payment or B Bond redemption. The B Bond interest application shown in 1984 through 1987 would be reduced by $3.22 million to service the A Bonds.

9. Calculation of the accrued interest is complicated, but it is estimated that as of December 31, 1987, $179.3 in B Bonds plus $34.39 in B Bond interest will be due. The total principal and interest of $213.69 compares with $204.6 shown on the cash flow. The small amount of the variance is attributed to the reduction of $43.8 million in B Bonds issued.

E. *Effect of A Bond Overhang*

Even if the $46 million in A Bonds are not satisfied by *Valuation Case* proceeds, the burden on the reorganized company would be ameliorated by the fact that unsatisfied A Bonds are extended for 10 years and satisfied by 10 annual installments.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

Consolidated Rail Corporation, et al.,
Appellants,

(D.C. No. B-70-347 In Bankruptcy)

C.A. Misc. Record Nos. 78-8104 through 78-8174

(See pages following end of order for complete captions)

ORDER.

Upon consideration of motion by appellees, Trustees of the property of Penn Central Transportation Company, Debtor, for an order requesting the following relief:

1. Authorizing and directing the transmittal and filing, within three (3) days of the entry of such order, of a certified copy of the docket entries in lieu of the record,
2. Requiring each appellant, within seven (7) days of the entry of such an order, to advise the Trustees of the documents upon which they intend to rely,
3. Requiring the Trustees to assemble such documents, as well as any additionl documents upon which they intend to rely, and promptly to produce and distribute to each appellant a single joint appendix at no cost to appellants,

4. Requiring each appellant, within five (5) days of the entry of such order, to take such steps as may be necessary to docket these appeals,
5. Providing for the simultaneous docketing of these appeals upon expiration of such five (5) days period,
6. Consolidating these appeals,
7. Establishing an accelerated schedule for briefing and argument which would require appellants to file briefs within 21 days after the date established for the simultaneous docketing of these appeals, appellees to file briefs 14 days thereafter, and appellants to file reply briefs 7 days thereafter,
8. Setting a date for argument shortly after completion of the briefing, and the answers filed by certain appellants in response thereto,

It is ORDERED that the aforesaid motion by appellees-Trustees be and the same is hereby denied as presented; and,

It is further ORDERED that all appellants, if they have not already done so, lodge the requisite $50.00 docketing fee for each appeal with the Clerk of this Court not later than eleven (11) days from the date of this order. In the event of noncompliance with this provision, the affected appeals will be listed for dismissal for want of timely prosecution; and,

It is further ORDERED that the Clerk of the District Court for the Eastern District of Pennsylvania transmit for filing in this Court a certified copy of the docket entries in

the court below in lieu of the record, said transmission to occur within eleven (11) days of the date of this order; and,

It is further ORDERED that all appellants who desire to designate portions of the lower court record for inclusion in the appendix, do so by advising the appellees-Trustees in writing within eleven (11) days of the date of this order. A failure to timely so designate in compliance herewith will be considered a waiver of any appellants' right to designate; and,

It is further ORDERED that the appellees-Trustees prepare, file and serve a joint appendix for these appeals in accordance with a schedule which will be set forth below. The cost of the appendix is to be borne exclusively by appellees-Trustees in the first instance, subject to the provisions of Rule 39, F.R.A.P., upon final disposition of these appeals by this Court; and,

It is further ORDERED that all appeals from orders numbered 3451, 3455 and 3456 in D.C. No. B-70-347, as well as order No. 131 in D.C. No. B-70-347-H, and order No. 195 in D.C. No. B-70-347-C be and the same are hereby consolidated for all purposes; and,

It is further ORDERED that the parties to all appeals referred to in the preceding paragraph of this order abide by the following briefing schedule:

1. All briefs for appellants, whether such briefs are filed on behalf of individuals or group interests, are to be filed and served not later than June 26, 1978.

2. Brief for appellees-Trustees, and any other briefs which may be considered as an appropriate appellees' brief, and the consolidated joint appendix

are to be filed and served not later than July 26, 1978.

3. Reply briefs, if any, for appellants are to be filed and served not later than August 7, 1978.

No extension of time will be granted to any party for any reason and appellants in particular, amongst themselves, are urged to avoid in their respective briefs duplication of materials and arguments to the extent possible. In the event that any other appellees' briefs are filed in addition to the brief of appellees-Trustees, the same request is made; and,

It is further ORDERED that these appeals be listed for disposition on the merits at the earliest convenience of the Court.

For THE COURT,

T. F. QUINN

Clerk

Dated: May 19, 1978

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

American Dredging Cômpany, Burroughs Corporation, Dresser Industries, Inc. and Shell Oil Company,
(order 3451) Appellants, C.A. Misc. No. 78-8104

American Dredging Company, Burroughs Corporation, Dresser Industries, Inc. and Shell Oil Company,
(order 3455) Appellants, C.A. Misc. No. 78-8105

American Dredging Company, Burroughs Corporation, Dresser Industries, Inc. and Shell Oil Company,
(order 3456) Appellants, C.A. Misc. No. 78-8106

Amsted Industries Incorporated, Amoco Oil Company, Ashland Oil, Inc., Gulf Oil Corporation, Mobil Oil Corporation, Shell Oil Company, The Standard Oil Co. (Ohio), and Texaco, Inc.,
(order 3451) Appellants, C.A. Misc. No. 78-8107

Amsted Industries Incorporated, Amoco Oil Company, Ashland Oil, Inc., Gulf Oil Corporation, Mobil Oil Corporation, Shell Oil Company, The Standard Oil Co. (Ohio), and Texaco, Inc.,
(order 3455) Appellants, C.A. Misc. No. 78-8108

Amsted Industries Incorporated, Amoco Oil Company, Ashland Oil, Inc., Gulf Oil Corporation, Mobil Oil Corporation, Shell Oil Company, The Standard Oil Co. (Ohio), and Texaco, Inc.,
(order 3456) Appellants, C.A. Misc. No. 78-8109

Bell System companies:

American Telephone & Telegraph Company, The Diamond State Telephone Company, Manufacturers Junction Railway, Western Electric Company, Incorporated,

The Southern New England Telephone Company, South Central Bell Telephone Company, Northwestern Bell Telephone Company, New Jersey Bell Telephone Company, The Mountain States Telephone & Telegraph Company, The Chesapeake & Potomac Telephone Company of West Virginia, The Chesapeake & Potomac Telephone Company of Maryland, The Chesapeake & Potomac Telephone Company, The Bell Telephone Company of Pennsylvania, The Pacific Telephone & Telegraph Company, Southwestern Bell Telephone Company, Southern Bell Telephone & Telegraph Company, Pacific Northwest Bell Telephone Company, The Ohio Bell Telephone Company, New York Telephone Company, New England Telephone & Telegraph Company, Michigan Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Cincinnati Bell, Inc., Illinois Bell Telephone Company, The Chesapeake & Potomac Telephone Company of Virginia,
(order 3451) Appellants, C.A. Misc. No. 78-8110

Bell System companies:

American Telephone & Telegraph Company, The Diamond State Telephone Company, Manufacturers Junction Railway, Western Electric Company, Incorporated, The Southern New England Telephone Company, South Central Bell Telephone Company, Northwestern Bell Telephone Company, New Jersey Bell Telephone Company, The Mountain States Telephone & Telegraph Company, The Chesapeake & Potomac Telephone Company of West Virginia, The Chesapeake & Potomac Telephone Company of Maryland, The Chesapeake & Potomac Telephone Company, The Bell Telephone Company of Pennsylvania, The Pacific Telephone & Telegraph Company, Southwestern Bell Telephone Company,

Southern Bell Telephone & Telegraph Company, Pacific Northwest Bell Telephone Company, The Ohio Bell Telephone Company, New York Telephone Company, New England Telephone & Telegraph Company, Michigan Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Cincinnati Bell, Inc., Illinois Bell Telephone Company, The Chesapeake & Potomac Telephone Company of Virginia,
(order 3455) Appellants, C.A. Misc. No. 78-8111

Bell System companies:

American Telephone & Telegraph Company, The Diamond State Telephone Company, Manufacturers Junction Railway, Western Electric Company, Incorporated, The Southern New England Telephone Company, South Central Bell Telephone Company, Northwestern Bell Telephone Company, New Jersey Bell Telephone Company, The Mountain States Telephone & Telegraph Company, The Chesapeake & Potomac Telephone Company of West Virginia, The Chesapeake & Potomac Telephone Company of Maryland, The Chesapeake & Potomac Telephone Company, The Bell Telephone Company of Pennsylvania, The Pacific Telephone & Telegraph Company, Southwestern Bell Telephone Company, Southern Bell Telephone & Telegraph Company, Pacific Northwest Bell Telephone Company, The Ohio Bell Telephone Company, New York Telephone Company, New England Telephone & Telegraph Company, Michigan Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Cincinnati Bell, Inc., Illinois Bell Telephone Company, The Chesapeake & Potomac Telephone Company of Virginia,
(order 3456) Appellants, C.A. Misc. No. 78-8112

The Chessie Railroads (The Chesapeake & Ohio Railway Company, The Baltimore & Ohio Railroad Company, Western Maryland Railway Company, Staten Island Railroad Corporation, The Dayton Union Railway Company and The Baltimore & Ohio Chicago Terminal Railroad Company),
(order 3451) Appellants, C.A. Misc. No. 78-8113

The Chessie Railroads (The Chesapeake & Ohio Railway Company, The Baltimore & Ohio Railroad Company, Western Maryland Railway Company, Staten Island Railroad Corporation, The Dayton Union Railway Company and The Baltimore & Ohio Chicago Terminal Railroad Company),
(order 3455) Appellants, C.A. Misc. No. 78-8114

The Chessie Railroads (The Chesapeake & Ohio Railway Company, The Baltimore & Ohio Railroad Company, Western Maryland Railway Company, Staten Island Railroad Corporation, The Dayton Union Railway Company and The Baltimore & Ohio Chicago Terminal Railroad Company),
(order 3456) Appellants, C.A. Misc. No. 78-8115

Committee of Interline Railroads,
(order 3451) Appellant, C.A. Misc. No. 78-8116

Committee of Interline Railroads,
(order 3455) Appellant, C.A. Misc. No. 78-8117

Committee of Interline Railroads,
(order 3456) Appellant, C.A. Misc. No. 78-8118

Consolidated Edison Company of New York, Inc., Philadelphia Electric Company, Pennsylvania Power & Light Company, Baltimore Gas & Electric Company, Duquesne Light Company and Evans Products Company,
(order 3451) Appellants, C.A. Misc. No. 78-8119

Consoliated Edison Company of New York, Inc., Philadelphia Electric Company, Pennsylvania Power & Light Company, Baltimore Gas & Electric Company, Duquesne Light Company and Evans Products Company,
(order 3455) Appellants, C.A. Misc. No. 78-8120

Consolidated Edison Company of New York, Inc., Philadelphia Electric Company, Pennsylvania Power & Light Company, Baltimore Gas & Electric Company, Duquesne Light Company and Evans Products Company,
(order 3456) Appellant, C.A. Misc. No. 78-8121

Six months priority claimant group consisting of Federal Transportation Company, Inc., Frank and Vincent Visceglia, Federal Storage Warehouses, Inc. and Peddie Buildings,
(order 3451) Appellant, C.A. Misc. No. 78-8122

Six months priority claimant group consisting of Federal Transportation Company, Inc., Frank and Vincent Visceglia, Federal Storage Warehouses, Inc. and Peddie Buildings,
(order 3455) Appellant, C.A. Misc. No. 78-8123

Six months priority claimant group consisting of Federal Transportation Company, Inc., Frank and Vincent Visceglia, Federal Storage Warehouses, Inc. and Peddie Buildings,
(order 3456) Appellant, C.A. Misc. No. 78-8124

FORD MOTOR COMPANY,
(order 3455) Appellant, C.A. Misc. No. 78-8125

FORD MOTOR COMPANY,
(order 3456) Appellant, C.A. Misc. No. 78-8126

General Motors Corporation,
(order 3451) Appellant, C.A. Misc. No. 78-8127

General Motors Corporation,
(order 3455) Appellant, C.A. Misc. No. 78-8128

General Motors Corporation,
(order 3456) Appellant, C.A. Misc. No. 78-8129

Syntonic Technology, Inc.,
(order 3451) Appellant, C.A. Misc. No. 78-8130

Syntonic Technology, Inc.,
(order 3455) Appellant, C.A. Misc. No. 78-8131

Syntonic Technology, Inc.,
(order 3456) Appellant, C.A. Misc. No. 78-8132

Trailer Train Company,
(order 3451) Appellant, C.A. Misc. No. 78-8133

Trailer Train Company,
(order 3455) Appellant, C.A. Misc. No. 78-8134

Trailer Train Company,
(order 3456) Appellant, C.A. Misc. No. 78-8135

The Bank of New York, as successor trustee under The New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage dated October 1, 1913,
(order 131) Appellant, C.A. Misc. No. 78-8136

The Bank of New York, as successor trustee under The New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage dated October 1, 1913,
(order 195) Appellant, C.A. Misc. No. 78-8137

The Bank of New York, as successor trustee under The New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage dated October 1, 1913,
(order 3455) Appellant, C.A. Misc. No. 78-8138

BANKERS TRUST COMPANY,
(from order 3/17/78 governing voting on Amended Plan of Re-
organization) Appellant, C.A. Misc. No. 78-8139

BANKERS TRUST COMPANY,
(from order 3/17/78 approving the Amended Plan of Reorgan-
ization) Appellant, C.A. Misc. No. 78-8140

Bankers Trust Company, as trustee under the New York Central and Hudson Railroad Company Consolidation Mortgage dated June 20, 1913,
(order 3455) Appellant, C.A. Misc. No. 78-8141

Irving Trust Company, as Indenture Trustee,
(order 3455) Appellant, C.A. Misc. No. 78-8142

MANUFACTURERS NATIONAL BANK OF DETROIT, Indenture Trustee under Lake Shore Collateral Indenture,
(order 3455) Appellant, C.A. Misc. No. 78-8143

MANUFACTURERS NATIONAL BANK OF DETROIT, Indenture Trustee under Lake Shore Collateral Indenture,
(order 3456) Appellant, C.A. Misc. No. 78-8144

New England Merchants National Bank,
(order 3455) Appellant, C.A. Misc. No. 78-8145

Charles S. Jeffrey, a holder of The New York Central and Hudson River Railroad Company 3½ o/o Michigan Central Collateral Bonds,
(order 3455) Appellant, C.A. Misc. No. 78-8146

Wilmington Trust Company, as Successor Indenture Trustee under the New York Central and Hudson River Railroad Company, Michigan Central Collateral Indenture dated April 13, 1898,
(order 3455) Appellant, C.A. Misc. No. 78-8147

Madison Square Garden Center, Inc., Penn Plaza Ventures, Grand Central Building, Inc., New York Life Insurance Company, The Title Guarantee Company, Bankers Trust Company, as Trustee under Indenture amending Consolidated Mortgage and Deed of Trust dated as of September 1, 1963, Olympia & York 245 Park Avenue Company, Olympia & York 320 Park Avenue Company, Aetna Life Insurance Company and Lex-43rd, Inc.
(order 3455 approving the "Amended Plan of Reorganization dated 3/17/78)
Appellants, C.A. Misc. No. 78-8148

Madison Square Garden Center, Inc., Penn Plaza Ventures, Grand Central Building, Inc., New York Life Insurance Company, The Title Guarantee Company, Bankers Trust Company, as Trustee under Indenture amending Consolidated Mortgage and Deed of Trust dated as of September 1, 1963, Olympia & York 245 Park Avenue Company, Olympia & York 320 Park Avenue Company, Aetna Life Insurance Company and Lex-43rd, Inc.
(order 3455 approving the "Amended Plan for Reorganization dated 3/17/78, entered on 3/20/78 and order 3456 concerning the voting procedures, etc.)
Appellant, C.A. Misc. No. 78-8149

Madison Square Garden Center, Inc., Penn Plaza Ventures, Grand Central Building, Inc., New York Life Insur-

ance Company, The Title Guarantee Company, Bankers Trust Company, as Trustee under Indenture amending Consolidated Mortgage and Deed of Trust dated as of September 1, 1963, Olympia & York 245 Park Avenue Company, Olympia & York 320 Park Avenue Company, Aetna Life Insurance Company and Lex-43rd, Inc.

(order 3456 concerning the voting procedures to be used in connection with the "Amended Plan for Reorganization dated 3/17/78, etc.)

Appellants, C.A. Misc. No. 78-8150

ROSE ASSOCIATES,

(3/17/78 order governing voting on amended plan for reorganization)

Appellant, C.A. Misc. No. 78-8151

ROSE ASSOCIATES,

(3/17/78 order approving amended plan of reorganization)

Appellant, C.A. Misc. No. 78-8152

SIGMUND SOMMER,

(3/17/78 order governing voting on amended plan for reorganization)

Appellant, C.A. Misc. No. 78-8153

SIGMUND SOMMER,

(3/17/78 order approving amended plan of reorganization)

Appellant, C.A. Misc. No. 78-8154

Erie and Kalamazoo Railroad Company,

(order 3455) Appellant, C.A. Misc. No. 78-8155

The Mahoning Coal Railroad Company and
The Mahoning and Shenango Valley Railway Company,

(order 3455) Appellant, C.A. Misc. No. 78-8156

State of New York,

(order 3451) Appellant, C.A. Misc. No. 78-8157

State of New York,

(order 3455) Appellant, C.A. Misc. No. 78-8158

State of New York,

(order 3456) Appellant, C.A. Misc. No. 78-8159

JOSEPH A. SCHAFER, WITNEY W. IRONS, ALTON P. GAINER, EMIL MILAN, CAROL KUCHAR, LEO SUKALA, STEPHEN SLOBODA, CHARLES W. HANNON, and PHILIP MORTON,

(order 3455) Appellant, C.A. Misc. No. 78-8160

HARRIET SIGNER, SEYMOUR GILLMAN, ANNE FRANK, and McMASTER HOLDING CO., bondholders under the New York Central and Hudson River Railroad Co. Refunding & Improvement Mortgage, dated October 1, 1913 (the "R & I Mortgage"),

(3/17/78 order approving plan)

Appellants, C.A. Misc. No. 78-8161

Consolidated Rail Corporation,

(order 3451) Appellant, C.A. Misc. No. 78-8162

Consolidated Rail Corporation,

(order 3455) Appellant, C.A. Misc. No. 78-8163

Consolidated Rail Corporation,

(order 3456) Appellant, C.A. Misc. No. 78-8164

The Koppers Companies (Koppers Company, Inc., The General Crushed Stone Company, Asphaltic Concrete Corp., Lycoming Silica Sand Company and The Buffalo Slag Company),

(order 3451) Appellant, C.A. Misc. No. 78-8165

The Kopper Companies (Koppers Company, Inc., The General Crushed Stone Company, Asphaltic Concrete

Corp., Lycoming Silica Sand Company and The Buffalo Slag Company)
(order 3455) Appellant, C.A. Misc. No. 78-8166

The Kopper Companies (Koppers Company, Inc., The General Crushed Stone Company, Asphaltic Concrete Corp., Lycoming Silica Sand Company and The Buffalo Slag Company)
(order 3456) Appellant, C.A. Misc. No. 78-8167

The Saul Group (Saul, Ewing, Remick & Saul, James A. Clifford, Delaware Valley-York, Inc., Kershaw Manufacturing Co., Inc., Railway Track-Work Company, The Western Union Telegraph Company, John R. McKinney and Russell Billman Trucking, Inc.),
(order 3451) Appellants, C.A. Misc. No. 78-8168

The Saul Group (Saul, Ewing, Remick & Saul, James A. Clifford, Delaware Valley-York, Inc., Kershaw Manufacturing Co., Inc., Railway Track-Work Company, The Western Union Telegraph Company, John R. McKinney and Russell Billman Trucking, Inc.)
(order 3455) Appellants, C.A. Misc. No. 78-8169

The Saul Group (Saul, Ewing, Remick & Saul, James A. Clifford, Delaware Valley-York, Inc., Kershaw Manufacturing Co., Inc., Railway Track-Work Company, The Western Union Telegraph Company, John R. McKinney and Russell Billman Trucking, Inc.)
(order 3456) Appellants, C.A. Misc. No. 78-8170

United States of America,
(order 3455) Appellants, C.A. Misc. No. 78-8171

United States of America,
(order 3456) Appellants, C.A. Misc. No. 78-8172

General Electric Company,
(order 3455) Appellant, C.A. Misc. No. 78-8173

General Electric Company,
(order 3456) Appellant, C.A. Misc. No. 78-8174

(D.C. No. B-70-347 In Bankruptcy)

C.A. Misc. Record Nos. 78-8104 through 78-8174

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 78-1703; 78-2311; 78-2312

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor.

WILMINGTON TRUST COMPANY, as successor indenture trustee under the New York Central and Hudson River Railroad Company, Michigan Central Collateral Indenture dated April 13, 1898,
Appellant.

PETITION, PURSUANT TO F.R.A.P. 35 AND 40, FOR REHEARING.

TO THE HONORABLE JUDGES OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT:

Appellant, Wilmington Trust Company ("WTC"), as successor indenture trustee under the New York Central and Hudson River Railroad Company, Michigan Central Collateral Indenture dated April 13, 1898, ("MCC Indenture"), respectfully requests a Rehearing in respect of the judgment of this Court rendered by a panel of this Court comprised of Circuit Judges Aldisert, Gibbons and Higginbotham and dated February 26, 1979. This Court's judgment denied the Petition for Rehearing, or in the Alternative, Rehearing En Banc filed by WTC on January 25, 1979 (the "prior Petition").

WTC requests a Rehearing on the ground that the decision of the panel denying WTC's prior Petition was based upon material factual errors which were contrary to the facts established in the record.

1. In denying WTC's prior Petition, the panel stated:

> "In this appeal neither the Wilmington Trust nor Manufacturers National Bank made any objection in their briefs or at oral argument to the diversion of the Park Avenue rentals . . ." (Slip Op. at 2).

With deference to the Court, this finding is in error. WTC specifically objected to the diversion of the Park Avenue rentals both in its Opening Brief and in its Reply Brief filed with this Court. Thus, in its Opening Brief, WTC stated:

> "Unlike other 'super-secured' creditors the MCC Indenture looks to the extremely valuable Park Avenue Properties, the income of which has been financing PCTC's reorganization proceeding for the past seven years, and substantially all the stock of the Michigan Central, one of PCTC's largest and most valuable leased lines." (Opening Brief at 7).

This objection was reasserted by WTC in its Reply Brief:

> "The Park Avenue properties are unique; for, as this Court has noted, the properties are an essential ingredient to any reorganization of the Debtor. *In re Penn Central Transportation Co.*, 484 F.2d 323, 334 (3d Cir.), *cert. denied*, 414 U.S. 1079 (1973). It is difficult to imagine how long this proceeding would have lasted if it had not been for the use of the Park Avenue rentals which exceeded $76,000,000, net of taxes. The MCC Indenture should not be penalized by subjecting this unique asset to the payment of administrative claims because it has, in effect, supported this reorganization." (Reply Brief at 10).

It should be noted that the figure $76,000,000 is the number asserted by the New York Central R & I Mortgage (the "R & I Mortgage"), and has not been reduced by approximately $16,000,000 in improvements.

2. As its second, and only other ground for denying WTC's prior Petition, the panel stated:

> "Nor did either indenture trustee rely upon the availability of such assets in the extensive liquidation analyses presented to this court." (Slip Op. at 2).

With deference to the Court, this finding is in error. WTC specifically set forth the Park Avenue rentals in its liquidation analysis presented to this Court. WTC argued that if the Park Avenue rentals are included, they increase the collateral securing the Gold Bond Mortgage and that the increase passes down to the MCC Indenture, making the MCC Indenture even more secured in a liquidation. WTC argued:

> "If the value of the collateral securing the Gold Bond mortgage is increased by the addition of the Harlem Lease ($48.2 million) or increased to take into account the rental payments received by the estate on the Park Avenue properties ($76 million), the excess over 200% which passes down to the MCC Indenture is further increased, thereby making the MCC Indenture even more secure." (Reply Brief at 12).

3. WTC's claim to the Park Avenue rentals was asserted as early as February 23, 1972 when WTC's predecessor indenture trustee sought an order sequestering the

rentals from the Park Avenue properties. Joint Appendix Vol. II, A-1, A-11; see *In re Penn Central Transportation Company*, 354 F. Supp. 717, 746-747 (E.D. Pa. 1972), *aff'd*, 484 F.2d 323 (3d Cir. 1973) *cert. den.* 414 U.S. 1079 (1973).

4. Within the 013-015 mortgage chain, the MCC Indenture's priority over the claim of the R & I Mortgage has been consistently asserted by WTC (e.g., Brief of WTC, dated July 18, 1977 [Reorganization Court Doc. No. 13,737] at 28). This priority has been recognized by the Debtor's trustees and by the trustee under the New York Central and Hudson River Railroad Company Consolidation Mortgage, whose position within the 013-015 chain is junior to that of WTC and senior to that of the R & I Mortgage trustee (Brief of the Debtor's Trustees dated July 11, 1977 [Reorganization Court Doc. No. 13,691] at 206; Brief of Appellant Bankers Trust Company dated June 24, 1978 at 12-13). Finally, this priority was conceded by counsel for the R & I Mortgage trustee (Transcript of Argument before The Honorable John P. Fullam, October 6, 1977, at 17,713).

5. Throughout the Reorganization proceedings, WTC has consistently asserted a claim to the Park Avenue rentals, a claim which no party has ever questioned as being superior to the claim of the R & I Mortgage. For the purpose of the Plan of Reorganization, the Debtor's trustees did not include the rentals as an asset securing the Gold Bond Mortgage or any of the other mortgages in the 013-015 chain. The R & I Mortgage took the lead in challenging that decision because under the Plan's distribution scheme (before the Reorganization Court established a separate super-secured class), it stood to benefit by an increase in Series A bonds if the rentals were included as an asset in the 013-015 chain. With the creation of a

super-secured class, WTC argued to this Court that the addition of the rentals would increase the collateral securing the Gold Bond Mortgage substantially above the level considered by the Reorganization Court in determining super-secured status, and as counsel for Debtor's trustees conceded, an increase of $76,000,000 would be sufficient to give the MCC Indenture super-secured status. (Transcript of Argument before the United States Court of Appeals, October 16, 1978, at 1-151).

6. These proceedings are admittedly complex. A myriad of issues have been raised and most have been considered by this Court. The issues raised by WTC's prior Petition were substantially identical to the issues raised by WTC in its briefs before this Court. On behalf of its bondholders, WTC asks only that this Court give consideration to the merits of the arguments raised by WTC both in its briefs and in its prior Petition.

Wherefore, WTC respectfully requests that this Court grant its Petition for Rehearing, vacate its judgment of February 26, 1979 and consider the merits of WTC's Petition for a Rehearing filed on January 25, 1979.

Respectfully submitted,

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